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The Stock and Produce Exchanges

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PREFACE

This volume embodies the results of a fairly continuous observation of the workings of the exchanges for more than fifteen years by the author, who during ten years of that time was a financial writer for American journals, and for nearly the same length of time has lectured on the exchanges to students at two universities in New York City. From the keen questions and discussions of scores of these students, many of whom have been and are connected with banking and brokerage concerns, much of the material in this book has been threshed out, and it has been the effort of the author to discuss the very questions that such teaching experience indicates are of vital interest to men in the business world.

In writing this volume, Mr. Atwood has drawn to some extent on the former volume of the Modern Business Text entitled, "Investment and Speculation." That volume was the joint product of Professor Thomas Conway, Jr. and Mr. Atwood. At this time it would be very difficult to trace the authorship of the different sections of that book but Professor Conway graciously consented that any portion of the text which Mr. Atwood desired to use in the present volume might be incorporated in it. Mr. Atwood desires to express his appreciation of this

courtesy and to acknowledge also the assistance of Mr. Louis Gottlieb, at one time Fellow in Economics, Sociology and Politics at Columbia University, who assisted him in gathering the material for the book.

In its present form the volume is a rewriting and rearrangement of the material contained in the author's Text published by the Institute under the title "The Exchanges and Speculation" together with considerable new material. In this revision the author had the assistance of the Editorial Department of the Institute. In rearrangement of the material the Institute had the counsel and advice of Professor S. S. Huebner of the University of Pennsylvania. The latter distributes to his students in the course on The Stock and Produce Exchange Markets, copious mimeographed notes which form an unusually complete treatment of the subject. These notes proved of great value in working out the new material and in some places were closely followed.

To all those who in one way or another have contributed to the volume in its final form our sincere thanks are due, and this obligation is recognized with pleasure.

JOSEPH FRENCH JOHNSON.

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THE STOCK AND PRODUCE EXCHANGES

CHAPTER I

FUNCTIONS OF STOCK EXCHANGES

1. *What are exchanges?*—The stock or produce exchange of today seems like a vast and complicated piece of mechanism; yet it can be traced back to very simple beginnings. It was not so very long ago that men traded or bartered goods. Jones and Brown would meet at some open place, display their possessions, and if they came to a mutual understanding a sale or transaction resulted.

As the number of individuals trading and the volume of transactions increased such places developed into trading centers, fairs, bazaars or so-called markets. In course of time a class of men grew up who did nothing but trade in these places. In markets for certain classes of goods, especially where the buying and selling are done on a large scale, elaborate rules and regulations have been evolved which govern the transactions and the methods for carrying them on. Thus the market place has become one of the most

important of modern business institutions, an exchange.

These exchanges have developed along two main lines, those where speculation and investment in stocks and bonds are conducted, and which are known as stock exchanges; and those which provide a place for dealing in grain, cotton, coffee or other agricultural produce, these being known as commodity or produce exchanges or sometimes as boards of trade. It is with these two great groups of institutions that this Text deals. Their most distinctive feature perhaps lies in the fact that the goods which are bought and sold do not actually appear on the exchange, but are traded in by mere description, or at the most by occasional samples. Jones and Brown do not display or trade their wares on the exchange, but buy and sell promises or contracts, with the assurance that the rules and regulations of the exchange will enforce the delivery of the goods according to contract.

The words market and exchanges as names for these great trading places are almost interchangeable. But it is important to note that the term "market" has come to mean something more than a place for trading. It is used to describe the collective mind that finds expression in the fluctuating prices at which property is bought and sold. One of the leading financial dictionaries defines the word "market" as follows: "In general the meaning is the predominating feeling as to values." We speak of the market as a person.

"Thus we say," writes Theodore H. Price in the Outlook, "that the market is 'strong,' or 'weak' or 'panicky,' 'tired,' 'hungry,' or 'asleep,' and attribute to it almost every emotion felt by the individual."

In this sense the term "market" has come to be synonymous with "exchange." When we say "the stock market," we mean the stock market on the stock exchange and, nine times out of ten, we mean the stock market on the largest stock exchange.

2. *Importance of exchanges.*—At first thought it may seem a curious fact that organized markets, or exchanges, should exist only for securities and a few agricultural products. Why are there exchanges for stocks, wheat and cotton, but none for loaves of bread and men's shirts? The reasons are simple enough. Wheat, corn, cotton and the like are produced by many small separate units, but are consumed in vast quantities by a relatively few manufacturers, exporters and the like. The importance of a central market to which the millions of units flow to form the needed mass is obvious. But loaves of bread and shirts are produced in comparatively few establishments from which they must spread out thru tens of thousands of retail stores in separate units to millions of consumers.

Like bushels of wheat or bales of cotton, stocks and bonds can be dealt in by the mass. It is not necessary to see each stock or bond certificate. Each share of common stock of the United States Steel Corporation is like hundreds of thousands of others.

Given only the name, price and quantity, men can "trade." Usually the consumer wants to see every hat and necktie he buys, so there must be thousands of places in which these and similar articles are displayed. But the physical appearance of a stock or a bond is not what determines its desirability, consequently the buying and selling can be concentrated.

There are many persons dealing in stocks, bonds, wheat, cotton and other produce off the exchanges. One authority has estimated that of the entire commerce of the United States in stocks, grain and cotton, probably less than five per cent is conducted on the exchanges, "and yet all the business of the country is attuned to the tone of these exchanges and reflects the confidence or doubt of the collective public mind to which they give expression. . . . It seems reasonable to assume that the American public directly affected by the changes in value registered on our exchanges includes about 11,000,000 people."

3. *Stock exchanges give mobility to property.*—The development of industry would be impossible without a gathering together of many small sums of capital into the large funds which are employed by corporations. This process depends in turn upon the freedom with which the units of title or ownership in corporations pass from hand to hand. This freedom is attained only thru some form of market, and the stock exchange is the most important of such markets.

All transactions in the stock market are recorded, and the publicity that is given to quotations enables

the security-holder to know the combined judgment of those who trade in his securities. Such quotations will reflect, over a period of time, the earning power of corporations and show what are the favorable or unfavorable securities for investment. In this way investment funds are attracted to the profitable industries. In the same way the unprofitable businesses are pointed out and investment in them discouraged.

Bankers, whose first duty is to their depositors, are more likely to lend freely upon securities in which transactions are publicly recorded. The banker desires frequent information concerning the value of the collateral behind his loans. Naturally nothing gives property so much mobility as free access to bank loans.

4. *Centers of world news.*—The stock market is able to render this useful service of directing capital into proper channels because it is the center of world news. Most of the large stock exchanges are not simply local markets but are distinctively world markets. Thru modern means of communication by wireless, cable, telephone and telegraph these exchanges are in touch with all the news of the world which has any business significance. This information, whether industrial, financial, commercial, political or social, is considered and studied by many trained minds and their conclusions and judgment are shown thru their purchases and sales, which are recorded by the exchange thru the publicity of quotations.

These quotations or prices appear within a few minutes of their making on thousands of "tickers" thruout the country and hundreds of private wires leased by brokers in all parts of the United States and Canada. They are cabled to all the leading cities of Europe and published on the financial pages of newspapers thruout the world. The information gratuitously given thru these quotations and showing what is accepted as the actual selling price of a security is of vast importance to the small investor, who may neither have the time, ability nor information at hand to analyze for himself the conditions and influences that affect prices.

5. *An ever-ready market.*—The stock market does more than furnish its quotations or prices free of charge to the public. It affords an ever-ready market for those securities which have been listed, or admitted, to the exchange. The owner of such stocks and bonds can practically always, at a moment's notice, learn thru a broker the going price of his holdings, a price at which he can actually dispose of them. Listed securities can to all intents and purposes be converted at any time into cash, sometimes at a loss and sometimes at a profit. There are many forms of property of course which have no such immediate or ready market.

It is nearly always possible to buy or sell securities on the exchange on a moment's notice because there exists a group of professional speculators, some of whom are always ready to buy and others to sell.

No matter what the nature of the price movement may be these men are willing to participate. If they did not exist the investor would often find no one to whom he could sell or from whom he might buy.

6. *Trading regulated.*—It was stated at the outset of this chapter that as the volume of trading increased, it was necessary to pass rules and regulations to govern it. As this is of exceptional importance in the protection of the patrons of the stock markets, the reader's attention is directed to the remarks in this connection made by Dr. S. S. Huebner, of the University of Pennsylvania.

Importance must also be attached to the protection and safeguards which organized stock exchanges give the stock and bond holder, in regulating brokerage transactions and maintaining a standard of commercial honor among brokers, much higher than would otherwise exist. It is not to be wondered at that in the free buying and selling of such a vast amount of flexible and easily transferable property as corporate stocks many questionable practices should have arisen, which only time will see eliminated. In this connection it should be remembered that the constitution of nearly every stock exchange defines the object of the exchange as follows: "Its object shall be to furnish exchanges, rooms and other facilities for the convenient transaction of business by its members, as brokers; to maintain high standards of commercial honor and integrity among its members, and to promote and inculcate just and equitable principles of trade and business." No person can be elected to membership until he has signed the constitution of the exchange, and by such signature he obligates himself to abide by the same, and by all subsequent amendments thereto. The value of this organization becomes apparent when we take account of the gigantic frauds per-

petrated upon innocent investors thru advertising campaigns by persons unaffiliated with any recognized exchange, or by certain members of unorganized curb markets.

All stock exchanges provide for the arbitration of disputes which may occur between members, and, if both parties are willing, between members and their customers. They also prescribe rules governing the nature of contracts, the making of all offers, and bids, the registry and transfer of securities on the transfer books of the corporations, and the conditions upon which securities may be listed upon the exchange for trading purposes. Practically all stock exchanges also require that all transactions must be real, and that no fictitious or unreal transactions shall be permitted; that discretionary orders cannot be accepted by brokers; and that every member of the exchange must keep complete accounts, subject at all times to examination by a governing committee or any standing or special committee of the exchange, and under penalty of suspension, no member may refuse or neglect to submit such accounts, or wilfully destroy the same. Nor may any member, under pain of suspension (a serious penalty involving not merely the loss of the rights and privileges of membership, but also the stigma attaching to the member as a factor in the business community) be guilty of "any conduct or proceeding inconsistent with just and equitable principles of trade."

7. *Protection afforded listed securities.*—It is often with the greatest difficulty that an investor is enabled to discover the actual selling price of a security which is not listed on the stock exchange. The daily newspaper is the only source of information one requires to secure the price of listed stocks and bonds. Now and then interested and none too scrupulous parties may buy a stock furiously to create the impression that investors or speculators are eager to purchase. This is

a doubtful form of advertising which may mislead the observer as to the real popularity of a stock. But it is extremely expensive for those who engage in it and it plays a comparatively minor part.

In the main the prices of listed securities reflect the bona fide opinion of hundreds of thousands of individuals, including the most competent financiers, as to their worth. There are as good or better stocks and bonds off the exchange as on it, but to determine their worth requires more specialized knowledge.

It must not be understood that because a security is "listed" the exchange guarantees its merits. The exchange does not attempt to guard against unsatisfactory conditions arising in any corporation. A security may fall from a high level to a practically valueless condition. This does not mean, however, that the exchange does not exercise a guiding hand. It recommends that the listed corporations publish and send to their stockholders an annual report of financial condition. This rule is not compulsory but practically has the force of law as it is adhered to by nearly all corporations. Furthermore, a company whose stock is listed cannot secretly declare dividends by which only a few favored individuals receive the profit. Proper notice is required before dividends can be paid, or new issues of stock made. Many acts of a fraudulent nature are prevented by a large number of rules and regulations which are strictly enforced. Moreover, while the stock exchange does not guarantee the worth of a security it does guarantee the

physical genuineness of the certificates which represent its securities.

8. *A barometer of future business conditions.*—The exchange not only protects the holder of securities from many possibilities of loss but it is also a "barometer of future business conditions." As we have seen, stock market quotations represent the combined judgment of trained minds, bankers and brokers, speculators and investors in all parts of the world who are buying and selling securities by cable, telegraph and telephone. These persons are constantly looking ahead, seeking to spy out future business and financial conditions. If they look for an improvement in business they buy stocks and if they fear a depression they are inclined to sell.

Thus the stock market is always ahead of the real conditions of the country, as it is ever striving to forecast the future. An advance in the general level of stock prices has always preceded a boom in business and in like manner the general level of stock prices declines before business activity reaches its height, thus forecasting business depression. By means of the stock market "coming events cast their shadows before." Every business depression this country has ever seen has been indicated anywhere from six months to two years in advance. The importance of this discounting function to the business man should not be overlooked.

The up-to-date business man whether he be manufacturer, merchant or real estate dealer, knows that

the stock market is not a separate market by itself, but that it concerns itself with all markets. It is the long general trend of the market either upward or downward that is of the greatest significance. Minor fluctuations which may be the result of some local event or condition are of lesser importance. Depending on the general direction the market takes, business men will develop or curtail their business operations. It is because of this discounting function of the stock market that it has been called "a barometer of business conditions."

9. *Short selling.*—Another function of the stock market is performed thru short selling. There is a great deal of popular prejudice against this practice, because the general public is not acquainted with its theory or its methods. One constantly hears protests in our newspapers and legislative circles against it, but, before further discussion, it should be stated here that short selling is absolutely essential in an economic way to the sound operation of any stock exchange.

The short seller, or "bear" as he is often called. offers stocks for sale exactly as if he owned them, but instead of delivering shares which he owns he delivers those which he borrows for the purpose. He takes this action in the hope that prices will decline, and if his judgment is correct he is enabled to buy in stock at a price lower than he originally sold and thus repay his loan at a profit. The practice is criticized on the ground that it unduly depresses the price

of property by the action of those who do not own any of that property. It would probably be impossible however to conduct an organized stock market in boom times, in particular, without short selling, for it is largely in this way that the worst extremes of inflation are prevented.

The short seller sometimes continues to sell after prices have suffered a great decline, and this is distinctly harmful. But in the long run there is less short selling of this nature than of stocks which have reached unwarranted heights of inflation. Then, too, while a few speculators continue to sell at the bottom, the larger number who have sold short when prices were high are very busy "covering," or buying in their commitments at the lower prices. This means they are buying stocks when such buying is most needed and when investors are too frightened to make purchases.

Owing to this enforced buying on the part of the shorts after prices have fallen, it is generally considered that the strongest stocks are those in which there is a large short interest. When the entire market is falling, stocks in which there is no short interest decline more violently and less gradually than those which are held up by the enforced buying of the shorts. The commission appointed by Charles E. Hughes during his tenure of the office of Governor of New York to investigate the New York Stock Exchange reported as follows concerning short selling:

"We have been strongly urged to advise the prohibition or limitation of short sales, not only on the theory that it is wrong to agree to sell what one does not possess but that such sales reduce the market price of the securities involved. We do not think that it is wrong to agree to sell something that one does not now possess, but expects to obtain later. Contracts and agreements to sell and deliver in the future, property which one does not possess at the time of the contract are common in all kinds of business. The man who has 'sold short' must some day buy in order to return the stock which he has borrowed to make the short sale. Short-sellers endeavor to select times when prices seem high in order to sell, and times when prices seem low in order to buy, their action in both cases serving to lessen advances and diminish declines of price. In other words, short-selling tends to produce steadiness in prices, which is an advantage to the community. No other means of restraining unwarranted marking up and down of prices has been suggested to us."

10. *A means for making settlements.*—We have already called attention to the fact that the stock exchange is an ever-ready market. It is due to this fact that stocks and bonds are so extensively used as collateral for loans. The lender of money knows that stock exchange securities can be sold more readily than any other class of property. This fact may be illustrated by the experience of the fire insurance companies after the San Francisco conflagration that followed the earthquake of April, 1906. Everyone knows that insurance companies do not keep on hand sufficient cash funds to meet the payment of such large claims as would be incurred by a conflagration of this magnitude. The companies

were able to make settlements with their policy holders involving millions of dollars within a short time, however, because their funds were invested in securities which could be sold readily.

The enormous sales of American securities in this country on behalf of the allied governments, especially England, from almost the beginning of the world war down to the end of 1920, is another illustration of how settlements are made on the stock exchanges. Several billion dollars of American stocks and bonds were resold in this country for the British Government, and it is known that a large part of them were liquidated on the stock exchange. Without this recourse the British would have been much harder pressed than they were.

The ability to sell stocks and bonds on the great stock markets is also of assistance in foreign trade. Let us suppose a New Yorker owes a Londoner for a bill of goods. His indebtedness could be cancelled by shipping gold to London. This may be a rather expensive medium; transportation charges, handling and insurance must be considered in the cost. If the New Yorker could find a Londoner who owes money in New York and get him to settle his London obligation and he in turn settle the Londoner's New York obligation he would be able thus to make settlement cheaper than by shipping gold. To do this the New Yorker would not necessarily go hunting for some one in the same position as himself, that is, wishing to cancel an international debt. He would find

him indirectly thru a foreign exchange dealer.

But one of the means by which the foreign exchange dealer who has stock market affiliations could cancel this obligation is thru the medium of securities, which is at times the most convenient and profitable method. He would effect this settlement thru the practice known as arbitraging. Desiring to remit funds to London he may sell a security there, and simultaneously buy an equivalent number of shares of that security in New York. It would be unnecessary then for him to send money to London because the London purchaser's indebtedness to him for the security could be used to cancel the account which he might otherwise ship gold to London to cancel.

In the case of an isolated transaction it would now be necessary for the New Yorker to forward to London the shares he had purchased in New York. Since, however, thousands of these arbitrage transactions take place daily he has no doubt been able to buy his securities from some British merchant who needs to make a payment in New York. In this way the transactions offset each other in the long run; in comparison with the volume of business done by means of arbitrage very few certificates of stock have to be sent overseas in either direction. This illustrates the theory of arbitrage. In actual fact, the business is handled by concerns expert in its most intricate features. They always have on hand securities for the conduct of their business, so that the actual buyers and sellers in each country are never in

personal contact. They merely add to or take from the stream of business the amounts they need for the settlements they want to make thru this means. In this way, by buying securities in New York and selling them in London, or vice versa, an international settlement may be made without the shipping of gold.

The practice of arbitrage tends to bring about an approximation of prices on the large exchanges the world over. It is due to our modern wire communication that when the price of a security in one market varies from the price quoted in another, the difference is immediately taken advantage of. Men buy in one market and sell in another simultaneously, and this practice of arbitraging has the effect of levelling prices the world over.

REVIEW

How do you account for the development of stock exchanges?

What functions do stock exchanges perform?

What do you understand by the statement that stock exchanges give mobility to property?

State what your idea is of an ever-ready market?

Enumerate five ways in which exchanges regulate trading.

In what way does the stock market act as a "barometer of future business conditions?"

Do you believe short-selling should be permitted? If so, how would you justify its existence?

CHAPTER II

LEADING AND OTHER EXCHANGES

1. *International and local centers.*—The exchanges which are dominant in their own countries and at the same time have an international importance are those of New York, London, Paris, Berlin and Amsterdam. Besides these there are a considerable number of other exchanges which reflect the activities of the financial centers but which primarily furnish a market for the purchase and sale of securities of local interest.

A large part of the present volume will naturally be devoted to the consideration of the New York Stock Exchange. A few of the salient points in its history and operations should receive attention at this point in order that a more intelligent comparison may be made with other leading exchanges of the financial world.

2. *New York Stock Exchange.*—In 1792, twenty-four men, who called themselves "Brokers for the Purchase and Sale of Public Stocks," met under an old tree on Lower Wall Street and formed the organization which was destined to play by far the most important rôle in the financial history of the United States. The business of the organization

remained small until the year 1817, when the public debt had increased to $109,000,000. Later the discovery of gold in California gave impetus to speculation and the increase in national wealth enlarged the volume of trading done on the Exchange. When the period of the Civil War was reached, it became an essential factor in the national financial life, the expansion of the national debt and the suspension of specie payments all helping to whet the speculative appetite. After the war railroad construction went on at increasing pace and the industrial development of the country received more and more attention. The creation of corporations and combinations made the Exchange an extremely busy place and the center for trading in the United States. Today, by far the largest single market for stocks and bonds in America is the New York Stock Exchange. Here, as on all exchanges, there is a large element of speculation, and as speculation is more extensive in stocks than in bonds, sales of stock far exceed those of bonds. Over a period of years the average annual turnover in stocks on the New York Exchange exceeds sixteen billion dollars, while that in bonds is about one billion. Many classes of bonds are indeed more extensively bought and sold off the exchange than on it. Yet half a billion dollars of new bonds are "listed" yearly and in no single place off the exchange does such a huge market for bonds exist.

3. *The London Stock Exchange.*—Americans have just reason to be proud of the elaborate and easy

running machinery of the New York Stock Exchange. In some respects it is superior to any in the world, but it is not so large as the London Stock Exchange, and in many respects it is not so important. The more closely an American investigates the London market for securities, the less boastful does he become of his own institutions.

In many points the London and New York stock exchanges are similar and are in sharp contrast to those on the continent of Europe. It is equally true, however, that London, Paris, Berlin have much in common that is wholly unfamiliar to the practice of brokers in America.

The London Stock Exchange is but one institution among many that make London so powerful as a financial center, just as the New York Stock Exchange is but one element in Wall Street. "Lombard Street" to the Englishman has much the same general significance as the term "Wall Street" to an American. It includes the Bank of England, the joint-stock banks, the bill brokers and other moneyed institutions that go to make up what Walter Bagehot, the famous English financial writer, described as "by far the greatest combination of economic power and economic delicacy that the world has ever seen. . . . Money is economic power."

The first home of the London Stock Exchange was in the rotunda of the Bank of England. Later it moved to Lombard Street, then Change Alley, Sweetings Alley and Old Jonathan's Coffee House. The

latter place burned down in 1748 and in its place arose New Jonathan's Coffee House, which twenty-five years later was given the title of "The Stock Exchange." The record of this transaction reads "the brokers and others at New Jonathan's came to the resolution that, instead of its being called New Jonathan's, it should be called the Stock Exchange which is to be wrote over the door."

British government bonds, "consols," fluctuated so widely in price during the Napoleonic Wars that the increase in the number of transactions and membership of the exchange warranted a new building, which was constructed in 1801 in Capel Court. There were at that time five hundred members. The Constitution of the exchange as then amended and adopted remains to this very day in essence, altho new rules and regulations have been added to meet new conditions.

Membership is not limited as in most other exchanges. In 1910, there were five thousand and nineteen members and in 1923, about three thousand nine hundred.

To say that the membership is not limited, is not absolutely true, but it is obvious since there are only 20,000 membership shares and each member gets one and in some cases three shares the maximum number of members will be limited to about 7000.

A peculiar feature of the Exchange is the requirement that members must be re-elected yearly, as election is for one year only. Often one hundred and fifty brokers drop out at the end of a year. In addition,

the committee may elect a few members each year without nomination. The founders of the Exchange devised this plan in order to prevent the raising of objections that it was or ever would tend to be monopolized by any one group.

4. *International scope of the London Exchange.*—During the war, the New York Stock Exchange began trading in many foreign securities, but normally the London Exchange carries on incomparably more international transactions. Dealings in foreign government bonds, railways and countless other enterprises play an exceedingly important rôle on the London Stock Exchange. One may gather an idea as to the variety of foreign trading done by reading the names of a few securities gathered from the *London Daily List,* the official register of the London Stock Exchange: Cape of Good Hope debentures: Municipal Stocks of Pernambuco; Harbor Board Mortgages of Oamaru and Wanganui, Honduras loans, loans to Brazil, Argentina, Siam, Costa Rica, Portugal, Straits Settlements; Malacca Rubbers, Singapore Electrics, Amazon Telegraphs, São Paulo Match Factories, and so on. The available supply of capital which England had at her disposal before the war to lend to undertakings carried on in distant parts of the world, has been considerably reduced.

The London Stock Exchange has four or five times as many members as its New York rival and quotes nearly 10,000 securities, altho those actually listed are about 5,000 as compared with 1,600 in New York.

While in certain respects the London market is far broader and vaster than that of the New York Exchange, in other matters its machinery seems more antiquated and clumsy. Speculation is more active and sustained in New York, but curiously enough the Britishers are more inclined to occasional excesses or manias of speculation.

5. *Continental bourses and American exchanges.*—The Paris Bourse has long been by far the most important of the continental stock markets and, before the war, was the second most important international stock market in the world, with total listed securities equaling those of New York. The bourse will be considered later, but first it may be well to note the common characteristics of all the continental stock markets.

Speculative accounts are rare in Europe. The people buy government securities or other investments recommended by their banks. Their speculative instincts are catered to by lotteries and occasionally by irresponsible, ungovernable gambling in wildcat shares. Organized speculation is confined far more to a few capitalists and professionals than it is in America. Speculators also borrow more directly from the banks and less from brokers than in New York. In London and Paris, brokers are forbidden to speculate on their own account, altho the London jobber whose operations are explained in a later chapter is nothing but a speculator.

Yearly reports of total sales are made by the De-

partments of Finance in France and Germany. In both countries the bourses are more under the control of the large banks and the government than in England or in the United States. In a single year the Bank of France deals in scores of millions of dollars of securities on the Bourse. Hours are uniformly shorter on the foreign bourses, an extreme case being that of the Amsterdam bourse which is open only from 1.30 to 2.45 P. M.

The most important respect in which all the European stock exchanges, including London, differ from those in the United States is in regard to settlement periods. The essential characteristic of the New York and most other American stock exchanges is the daily settlement for securities. In Europe settlements are usually made twice a month and in some instances only once a month.

6. *Paris Bourse.*—In essence the Paris Bourse is a private monopoly under government control. The brokers are practically government officials, appointed thru and under the supervision of the French Department of Finance by the President of the Republic. In some respects it is a primitive institution, without facility for swift transfer of stocks and the enormous speculation coupled with the utmost publicity of the New York Stock Exchange, or the efficiency and international scope of the London Stock Exchange. It is, however, far safer than either. Failures rarely take place. The brokers are among the most respected and leading financiers of the Republic.

The Paris Bourse was the result of spontaneous growth and has survived all the political and economic turbulence thru which so many French institutions have passed. Originally merchants had wares to sell and they sold them in markets. At first the bourses were given free play without government control, but there was fleecing and dishonesty. The Mississippi Bubble led to restrictions. It was then decided to turn the business of trading on the Bourse into a monopoly and to hold traders responsible not only for their individual acts but collectively for all the business transacted. In the period from 1720 to 1750 the Bourse assumed practically the form it has today.

In France there are two distinct kinds of exchanges, stock exchanges (*bourses des valeurs*) and commercial exchanges (*bourses de commerce*). According to this classification the names assigned to operators are "*agents de change*" and "*courtiers en marchandises.*" It is the first class that interests us at this point, as the Paris Bourse is a "*bourse des valeurs.*"

Altho the total of securities listed on the Paris Bourse about equals that in New York and is one-fourth that in London, the membership is limited to seventy, as compared with eleven hundred in New York and about seven thousand in London.

When a stockbroker who is a member of the Bourse wishes to retire, he does not sell his membership but merely disposes of "the right of introduction." The price of the latter fluctuates between $300,000 and $400,000. After the candidate, who must be a French

citizen, has satisfied the requirements of the government as to character and fitness, he is nominated and elected as an official of the Department of Finance. In addition to the cost of membership itself, a deposit of 250,000 francs or normally \$50,000 is required as a security upon which an interest rate of four per cent is paid, and a fee of 120,000 francs (\$24,000) is exacted which goes into the treasury of the Bourse. The combined memberships are now worth about twenty million dollars and there is no doubt that in time the membership will become still more valuable.

The government of the Paris Bourse lies in the hands of a Syndical Chamber, consisting of a syndic and eight members chosen from the seventy. This body corresponds to the Board of Governors of the New York Stock Exchange and the Committee of the London Stock Exchange, except that the Syndical Chamber is under the control of the Finance Department.

7. *Berlin Bourse.*—The Berlin Bourse has never been of much importance in itself, largely because the great banks of Germany have absorbed practically all dealings in stocks as well as many other economic functions. There is a horde of small brokers who pay a license fee on the Bourse, but the important men in the institution are the eighty official brokers who make the quotations and are closely related to the government. Most of these official brokers do business for the banks. Unlike France, England and Holland. Germany has never encouraged the invest-

ment of its citizens' funds in foreign enterprises, altho at various times considerable quantities of American railroad and industrial stocks have been held in Germany, especially Baltimore & Ohio, and Canadian Pacific. In the main, Germany has needed all her spare money at home so that Berlin has never become an international financial center.

8. *Effect of the war.*—On July 31, 1914, a financial earthquake occurred which shook every financial center of the civilized world. All the important exchanges of the world were closed one by one, until finally New York the last of all, suspended trading to prevent a situation that was bound to have been disastrous. The only other time the New York Stock Exchange closed its doors was for ten days during the panic period of 1873.

During 1914 the exchange was closed four and a half months which speaks for itself in showing the relative gravity of the two historic events. When the exchange again opened, trading was extended only to bonds. All transactions were required to be for "cash" or "regular way." The next step was to permit trading in stocks which were not international in character at or above certain prescribed minimum prices, and so, gradually, trading was eventually restored to a position where restrictions of this sort were no longer necessary.

Upon the three great markets of Europe, those in London, Paris and Berlin, the war placed innumerable restrictions. For a long period they were

entirely closed. The Paris Bourse, as well as that of Berlin, has not yet recovered its former greatness.

On the London Exchange the alterations during the war are far too numerous to mention here. Some of the most striking changes which took place are these: Expulsion of a great number of members of German origin; enlistment of several thousand members; the passage of complicated rules forbidding all trading in securities issued in enemy countries or even in the issues of neutral and allied countries when they were owned by citizens of countries with whom Great Britain was at war, and the enactment of measures to force British members to sell foreign securities and to buy only British securities, chiefly government bonds. The restrictions placed upon the London Stock Exchange quickly forced its New York cousin into the world's first place. The rapidity with which London has regained the position it held previous to the war, has been a matter of world-wide surprise.

When the war started in 1914 no government was more ruthless in suppressing tell-tale speculation than the German. It believed that dealings in stocks at such a time were opposed to public interest; but so prosperous did some of the war munition makers grow that it became very difficult to stop operations in these stocks, as the following dispatch from Frankfort on July 10, 1916, indicated:

Altho no stock quotations are published in Germany at present, speculation at the different stock exchanges in Germany had lately attained such dimensions that conserva-

tive circles became alarmed and cast about for means to restrict dealing in stocks. The Chamber of Commerce in Berlin, supported by the "Board of Elders of the Stock Exchange," submitted to the government certain new regulations, which now have been adopted. They prohibit all transactions involving deliveries at some future date, permitting only the so-called cash business, which provides the fulfilment of every contract within three days. In order to prevent manipulation within this limited period all contracts are to be submitted to a commission appointed by the "Board of Elders of the Stock Exchange," which is authorized to determine the amount of damages due to the non-performance of a stipulation in the deals.

The calling out of quotations in a loud voice is forbidden; also advertising which would stimulate stock exchange business. Bankers and brokers are not to forward to their customers regular market reports; they are empowered, however, to reply to requests for information. The punishment for infraction of these rules is to be meted out by the "Board of Elders," who may exclude members till the end of the war, when all these new rules will automatically become void.

9. *Lesser exchanges.*—Besides the great exchanges of national and international importance there are a number of others which play a minor but not to be neglected part in the financial operations of nations. Some of them grow up in the shadow of the larger exchanges and devote their energies to securities which have no market in the latter. Others are to be found in centers of population removed from the financial center of the nation. The varied relations of these different exchanges to the dominant exchange and to the security market both national and local will appear in an account of the American exchanges. The New

York Curb Market, which has its analogues in London and in Paris will be treated more fully later. This description will therefore begin with an independent exchange existing in New York City before considering the exchanges of other places.

10. *Consolidated Stock Exchange of New York.*—One must be careful not to confuse the Consolidated Stock Exchange of New York with the New York Stock Exchange, altho both deal, for the most part, in the same securities. The Consolidated Exchange carries on small operations in a few mining shares and in some others not listed on the Stock Exchange, but it is essentially a secondary market for some of the more active and popular securities on the big Board. It is said that the Consolidated is the third largest market for securities in the country, ranking next to the New York Curb. The assertion is even made that, at times, its total sales equal the combined total of all the stock exchanges outside of New York City. At other times, however, its dealings do not much exceed those on the Boston Stock Exchange. It is rarely that the dealings on the Consolidated exceed one-fifth of those on the New York Stock Exchange.

The unit of trading on the Consolidated is ten shares, as on the London Stock Exchange, and it is a fractional or odd-lot market of no small proportions and importance. Of course, large transactions are often effected, but essentially this exchange is a market for small operations. In times of panic or of

unusual stress it often assumes increased importance, but for the most part it does not initiate movements in stocks and the prices on its floor tend to follow rather than to lead those on the New York Stock Exchange for the same securities.

While there are a number of very active commission brokers in the Consolidated, this exchange is noted for the fact that with a comparatively limited outlay, a man may become a member and trade on his own account. The Consolidated maintains a ticker service of its own. It trades, for the most part, in stocks already admitted to the New York Stock Exchange.

11. *History and description.*—The present Consolidated Exchange is an outgrowth of what was known, about four decades ago, as the New York Mining Stock Exchange. It was organized because of the necessity that arose of having separate quarters for the growing business done in mining shares. Two years later it absorbed its fifteen-months'-old rival, the American Mining and Stock Exchange and, in 1886, it added three more exchanges, the National Petroleum, the Miscellaneous Security Board and the New York Petroleum Exchange and Stock Board. At first the Consolidated conducted no business except that in mining stocks and petroleum pipe-line certificates, but it has long since ceased to deal in the latter and deals now only slightly in the former. The Consolidated has moved several times and now has a large building of its own at Broad and Beaver Streets. It has a slightly larger membership than the New York

Stock Exchange. In 1923 the cost of membership was about $2500.

12. *Stock exchanges outside New York.*—Outside of New York City there are a number of stock exchanges but for the most part they are of relatively small importance. Among the first twenty cities of the country there are six, Buffalo, Milwaukee, Newark, Minneapolis, Jersey City and Kansas City, which have no stock exchange. In the case of two of the cities the absence of a stock exchange is readily explained by the proximity to New York City; in the other cities the interest in grain and other produce overshadows that in securities.

Stock sales on the exchanges of the other cities for 1922, the cities being named in the order of their population, were:[1]

	Shares (Thousands)		*Shares (Thousands)*
Chicago	9,145	Pittsburgh	2,230
Philadelphia	2,617	Los Angeles	36,711
Detroit	2,677	San Francisco	135,546
Cleveland	833	Washington[1]	—
St. Louis	241	Cincinnati	168
Boston	5,223	New Orleans	13
Baltimore	485		

[1] Not compiled.

In forming any judgment as to the significance of these figures regard must be had for the stocks represented. In San Francisco and Los Angeles the

[1] This information was furnished to the Alexander Hamilton Institute thru the courtesy of the secretaries of the respective exchanges.

stocks traded in, for the most part mining stocks, have a very low value per share. Thus the San Francisco stock sales above noted represented only $17,594,188. The principal stock exchanges in the Dominion of Canada are those of Montreal and Toronto. Sales on the Montreal Exchange in the year 1922 amounted to 2,997,000 shares, while on the Toronto Exchange they aggregated 1,215,000 shares. The volume of business for the year was in Canada as well as the United States in most instances below the high-water mark of 1919.

Not only is the volume of business slight on the markets of most of the large cities in the interior and the character of the securities almost wholly local, but in such cities so large a part of the total volume of business is transacted over the counter of investment dealers, rather than on the floor of the exchanges, that the latter are reduced to a minor position.

13. *Services of the smaller exchanges.*—In general the exchanges outside of New York City deal in local securities. In a sense they serve the New York Stock Exchange somewhat in the same manner as does the Curb Market in trying out new securities. Enterprises which at the outset appear as local in scope expand to national proportions; and when they do so, they gravitate naturally to New York.

It is a fact which in no way minimizes the importance of other financial centers that when investors desire a broad, active, national market for any securities they want to offer for sale, they usually send them to New York. For this reason Philadelphia has long

since ceased to be the primary market for Pennsylvania, Lehigh Valley and Reading, three railroad stocks in which at various times the Philadelphia market had an important "say." Altho all the directors of the Pennsylvania Railroad live in the state of Pennsylvania and the company is absolutely ruled from its headquarters in Philadelphia, the only market of any importance for its stock is on the New York Stock Exchange. For a long time Lehigh Valley enjoyed an active market in Philadelphia but New York finally absorbed that also.

14. *Boston Stock Exchange.*—The Boston Stock Exchange occupies a prominent position because of the fact that Boston has long been the center of a very rich section. New England has supplied capital to the newer parts of the country from the earliest days of the railroad business. In other words, Boston has financed many of the country's largest enterprises, including many of the richest copper and zinc mining industries. But the New York Stock Exchange has already absorbed a large proportion of the trading in these securities and is constantly absorbing more and more of them as time goes on.

The Boston Exchange dates from 1834, when it was established as a market for the stock of New England railroads. Among the more important stocks in which this exchange deals and which have been largely financed by New England capital are American Telephone, American Sugar, American Woolen, General Electric, Swift and Company, United Fruit and

United Shoe. The primary market for most of these stocks, however, is now New York.

The Exchange had on its lists in 1923 the stocks of two hundred ninety-five different companies; by far the most active of these were the copper mining shares. In many cases they sell at very high prices, far above their par value. Calumet and Hecla, with a par value of $25 reached $1000 in 1907, its highest price.

15. *Chicago Stock Exchange.*—The exchanges of Chicago and Philadelphia probably rank next to Boston in importance, altho during the great European war both the Baltimore and Pittsburgh exchanges came into greater prominence.

The Chicago Stock Exchange has about two hundred and fifty members, and carries on a very active business. Several corporations which formerly listed their securities in New York alone, now allow them to be traded in on the Chicago Exchange. Many important local stocks are dealt in, such as Booth Fisheries, Chicago Railway, Chicago Telephone, Commonwealth Edison, Chicago Pneumatic Tool, Chicago Edison, Illinois Brick, Quaker Oats, Sears-Roebuck, Swift and Company and Union Carbide. A considerable volume of sales of bonds of local companies also takes place on the Chicago Exchange but it is noteworthy that many of these local Chicago companies enjoy a much more active market on the New York Stock Exchange. American Can, National Biscuit and Diamond Match companies which were originally promoted by Chi-

cago operators, now find their chief market in New York.

16. *Philadelphia Stock Exchange.*—The oldest stock exchange in the United States is the Philadelphia Exchange. Brokers and merchants who later formed the nucleus of the exchange at first met in the "London Coffee House," established in 1754. It was a "licensed place to which will come and be centered the news from all parts of the world. An exchange upon which our merchants may walk, and a place of resort where our chief citizens in every department of life can meet each other and converse upon subjects which concern the City and the State."

In its first roster are recorded the names of only ten members. This number was increased by eight in 1818. Since then expansion has been fairly rapid, and now the maximum membership permitted by the constitution—two hundred and thirty members—has been reached. The price of a seat is about $10,000 and listing requirements are very strict. With the exception of moderate quantities of railroad stocks most of the business is done in bonds and public utility shares.

17. *Pittsburgh Stock Exchange.*—On the Pittsburgh Exchange many local steel, oil, iron, natural gas and miscellaneous manufacturing stocks, together with a few local railroad shares, are traded in. As on the Philadelphia, Boston and Chicago exchanges, small quantities of United States Steel are bought and sold but the big market for this stock is New York.

Like the other exchanges, Pittsburgh has lost many stocks to New York, such as Crucible Steel, Pittsburgh Steel, Pressed Steel Car, and a number of others in which it was primarily interested.

REVIEW

How does the New York Exchange compare with the London Exchange in importance?

Point out some of the common characteristics of European stock exchanges, showing how they differ from those in the United States.

What kinds of stocks are traded in on the Consolidated Stock Exchange? How does it differ from the New York Stock Exchange?

What is the nature of the stock exchanges outside of New York, and what are the kinds of securities in which they deal?

CHAPTER III

THE NEW YORK STOCK EXCHANGE

1. *Legal status of the organization.*—The legal status of the New York Stock Exchange, as of most American stock exchanges, is distinctive. The Exchange differs from the ordinary business organization in that it is not organized for profit. It is neither a corporation nor a partnership but has some of the characteristics of both. It is a "purely private, voluntary, unincorporated association," having more of a resemblance to a voluntary society or club than to any other kind of an institution. However, it should be noted in passing that American produce exchanges are incorporated.

The stock exchange is similiar to a corporation in that it may adopt a constitution and by-laws which must be observed by its members, and also because its existence is perpetual and not affected by resignation, suspension, expulsion or death of any member or members. On the other hand it is unlike a corporation because it has no charter and its existence is not due to any statute or legislative act. The privilege of membership may be granted, refused, or withdrawn at the pleasure of the body.

The stock exchange is different also from a partnership. The members make no contribution of capital

and therefore do not share in each other's profit or losses. Neither is there any division among the members of any profits which may accrue to the association from fines, dues, assessments or from such property as it possesses and, furthermore, the dissolution of the organization is not effected by the death, resignation, suspension or bankruptcy of a member.

The private character of the stock exchange can readily be emphasized by a comparison with those in Europe. There is no special legislation controlling American exchanges; but for a broker on the Paris Bourse the manner of doing business and his rights are carefully prescribed by legislation. The exchanges in Germany are established and exist only by government permission and every phase of the exchange is subject to regulation by the state.

Demands have been made at various times to incorporate the American stock exchanges. Such demands have in the past been made in legislative inquiries and will probably be made again in the future. Horace White, chairman of the Hughes Commission, stated in this connection that "Under existing conditions, the Exchange is a society—a voluntary society. Its decrees are executed instantly, and the fact that punishment imposed for wrong-doing is certain to follow without delay is the most powerful deterrent that can be held over a member. Expulsion from the Exchange practically deprives a man of his vocation; but if he could appeal to the courts and raise a cloud of dust, postponing the decision for two or three years

until people have forgotten the case (and when, moreover, the final decision rests in the hands of lawyers instead of financiers), the effectiveness of the discipline would be very much impaired."

This voluntary, unincorporated association being without capital is not in business itself but each individual broker carries on his own separate business under rules and regulations of the association which protect both him and his client or principal. Its objects, as stated by the New York Stock Exchange, are to furnish "exchange rooms and other facilities where its members can properly carry on their business as brokers; to maintain high standards of commercial honor and integrity among its members; and to promote and inculcate just and equitable principles of trade and business."

2. *A seat on the exchange.*—One having membership in this association is said "to hold a seat." The word seat is a misnomer. In the early days brokers had seats in a room arranged like the ordinary legislative chamber but at the present time the business of the exchange is handled upon a great floor where brokers transact their business standing. A seat on the stock exchange is the collective privileges which a member receives under the constitution and by-laws of the exchange. As already stated the number of seats or memberships of the New York Stock Exchange is limited to eleven hundred.

Ownership of a seat cannot be said to be absolute and unqualified, as a member is limited and restricted

by certain rules of the Exchange. He cannot sell or bequeath his seat to any one he may see fit, for such a person must meet the approval of the committee on admission. The Exchange has power to deprive him entirely of the benefits of his seat for violating its rules. Neither does a member have a right to any share of the property of the Exchange upon his withdrawal from membership.

On the other hand it may be well to mention here what the interest of outside creditors is in the value of a member's seat in case a member becomes insolvent. The rules of most American stock exchanges give member creditors a prior claim over outside creditors to the proceeds from the sale of a seat. The rules of the New York Stock Exchange state that upon any transfer of membership, the proceeds thereof shall be applied to the following purposes and in the following order of priority: *First,*—the payment of all fines, dues, assessments and charges of the exchange against a member whose membership is transferred. *Second,* the payment of creditors, members of the exchange, or firms registered thereon, of all filed claims arising from contracts subject to the rules of the exchange, if, and to the extent that, the same shall be allowed by the committee on Admissions. If the proceeds are inadequate to meet such claims, distribution shall be made on a pro rata basis. *Third,* the surplus, if any, after meeting the above claims, shall be paid to the person whose membership is transferred or to his legal representative. The legality of

similar provisions in the constitution of stock exchanges has been questioned several times before the courts and such rulings have been upheld on the ground that there is no reason why a stock exchange should not make membership subject to such a rule, unless it be that it is in violation of some statute or of some principle of public policy.

The price at which a seat is sold varies with the supply and demand. The supply consists of the seats of members who retire, who desire to sell, or who die. There is no other way of securing membership. The demand, of course, consists of the number of persons desiring to become brokers on the Exchange. Prices for seats usually fluctuate in accordance with the volume of business activity on the exchange. The prices have ranged in recent years from $34,000 to $110,000, the higher amounts being paid for seats during periods of prosperity.

The price of membership is not so important as the membership itself. A membership is considered an asset of great value, for a member is entitled to a commission rate for his business which makes the cost of membership look very cheap to a person doing a large business. Suppose he were to pay $110,000—the record price for a seat—with money at five per cent, the interest cost would be $5,500 annually. If he were to buy and sell but one hundred shares a day he would have a commission for the year of about $12,000, or more than twice as much as the interest on the highest price ever paid for a membership.

Membership privilege allows a member to have his business transacted for him at members' rates which are lower than those charged the public, or he may buy and sell securities himself free of commission.

3. *Commissions.*—It is a universally accepted rule, to which all members must strictly adhere, that commissions shall be charged on all sales or purchases of securities that are made for others. Rebates in commissions either by direct action or by indirect means are forbidden and any violation of this rule brings serious punishment. For the first offense, the penalty is suspension for a period ranging from one year as a minimum to five years as a maximum, according to the facts of the case. Any member who is guilty of a second offense is expelled. A member who fails to charge a customer with the commissions authorized by the Exchange is considered as having granted a rebate and is punishable accordingly, and when a member is suspended for this or a similar offense, he is not permitted during the period of suspension to avail himself of the special rate of commissions allowed to members.

There is a rule of the Exchange, that all business, whether in buying or selling, transacted for parties who are not members of the Exchange and for firms in which the Exchange member is only a special partner, is chargeable on the basis of the selling prices of the securities. The commission rate is $25 per one hundred shares for buying or selling.

For members of the Exchange the commission

charge on railroad, public utility and industrial bonds, not specifically provided for, having more than 5 years to run, is not less than $37\frac{1}{2}$ cents per $1,000 par value. On subscription rights, bonds or notes of foreign countries, notes of corporations and bonds all having five years or less to run the rates are mutually agreed upon. Special rates may be fixed by the Committee on Quotations and Commissions with approval of the Governing Committee. On securities of the United States, Porto Rico, Philippines, the rate to members is not less than 20 cents per $1,000 par value.

4. *Admission requirements.*—The applicant for admission to the Stock Exchange must be a citizen of the United States, and at least twenty-one years of age. In order to have his application considered by the Secretary of the Exchange he must indicate two members who will vouch for his honesty, integrity and financial responsibility. Having fulfilled this requirement, he must then begin negotiations with the Secretary concerning a seat on the Exchange. After the payment of the initiation fee of $2000, he and his sponsors are summoned before the Committee on Admissions for examination. His personal history, condition of health and business experience are examined in elaborate detail and, if everything proves satisfactory, he is elected to membership and required to sign the constitution. The authorities are especially inquisitorial regarding the source of the funds which the candidate employs to buy the seat. This is because the Exchange fears that he may use money

to which some "string," or condition, is attached, and that the supposed owner, if he should get into trouble, might not have the capital with which to meet his obligations.

In brief, the reason for such painstaking exclusiveness is that the Stock Exchange desires a high degree of financial responsibility in those who join. Members cannot make distinctions in their operations. They must accept the first bargain offered—provided, only, the price is acceptable. Unlike most lines of business, the buyer or seller cannot draw any personal lines whatever, even when he thinks the other person's credit is not good. Nor is there any method by which this rule can be evaded. Since they are required to do business with the first fellow-member who presents himself, the members, as a rule, are naturally very careful whom they admit.

Dr. Weld in his "Marketing of Farm Products" gives an excellent summary of the advantages of insisting upon high membership values on the produce exchanges. His remarks apply equally well to stock exchanges. He says:

> The principal reasons for maintaining high membership values are to make it necessary for an individual to have some means before assuming the financial obligations incumbent on members, and to increase the disciplinary power of the exchange over its members. . . . It is necessary for the exchange to hold some club over its members to enforce its rulings. If a membership is valued lightly a member may be willing to run the risk of expulsion in order to be able to stoop to some illegitimate practice. If his member-

ship has a high financial value, he will be held more easily to the rules. Expulsion from one of the large exchanges carries with it not only financial loss but business disgrace. The more severe the restrictions on admission, the greater the disgrace from expulsion.

5. *Government of the Exchange.*—The government of the Exchange rests in an all-powerful governing committee, composed of the President, the Treasurer and forty members. There are also paid officials, a secretary and an assistant secretary, who are not members. The assistant secretary is the chief authority on technical details, while both these officials have many important duties. The governing committee is the final authority on nearly all matters; there are, in fact, few instances where a like committee is vested with such practically unlimited jurisdiction. This body resembles the board of directors of a corporation. It has power to appoint all committees and regulate their jurisdiction; it may also try all members for alleged offences and punish them if they are found guilty. It controls the finances of the Exchange and, since the Exchange is not incorporated, the committee may mete out punishment to offenders without being hindered by court action. It is thus free of practically all legal embarrassments and technicalities and can enforce its rulings rigidly and promptly. By way of discipline, according to the offense, the committee fines a member, removes his telephone, suspends him or expels him.

There are some fifteen committees in all, chosen

from among the members of the governing committee. This organization of the government of the Exchange at first glance seems complicated; in reality it is very simple, considering the magnitude of the business involved, and the complexity of the questions that constantly arise. The Exchange is a wholly self-governing body, a fact that is remarkable when one considers the vastness of the operations conducted under its auspices.

There is no necessity of describing the work of all the committees. The Committee on Admissions not only passes on all applications for transfer of seats, but has charge also of the reinstatement of suspended members. While the Governing Committee is exceedingly strict about dropping an insolvent member, they often offer opportunity for reinstatement. There are also committees that are concerned respectively with law, business conduct (the ethics of transactions), arbitration (disputes), the clearing house, stock list (admission of securities), and many other subjects. The work of the Committee on Stock Lists concerns matters which require detailed consideration and which will be treated in the next chapter.

6. *Interior of the New York Stock Exchange.*—(a) *The building.*—Outsiders were formerly admitted freely to the gallery, but permission is now somewhat more difficult to obtain. Newspaper men are never allowed to go on the main floor; they may enter only the secretary's office or the library, both far away from the place in which business is transacted.

FLOOR OF THE NEW YORK STOCK EXCHANGE

The present building of the New York Stock Exchange is a large structure facing upon Wall, Broad and New Streets. Only the first floor is used for trading; it is, however, an immense inclosure, with ample space for the transaction of business. Five other floors and the basement are used for the elaborate mechanical apparatus, including the complex cable, telegraphic and telephonic connections; for meeting rooms, committee rooms, officers' and employes' accommodations (members never have offices in the building unless they are also officers of the Exchange or of the building company), a luncheon club, smoking and lounging rooms, libraries, and similar comforts and conveniences.

(b) *The floor.*—The main floor of the Exchange is surmounted by a high dome which admits a generous supply of light and air. An air-cooling plant has been installed which minimizes the effects of excessive heat and humidity and keeps the trading floor well ventilated in spite of the crowds. Around the walls is a seemingly limitless number of telephone booths each of which is leased to some member of the Exchange. The members and their clerks use these telephones many times a day to communicate with their offices for the purpose of receiving orders and reporting the success of negotiations.

On the "floor" of the Exchange posts are scattered, at each one of which are posted the names of the stocks that are bought and sold at that point. The number

of stocks thus enumerated ranges from twenty to forty. There is, therefore, some particular place in the room for the purchase and sale of each listed security which, when once designated, is seldom changed.

For example, Atchison, the first stock on the alphabetical list, is at post 2; New York Air Brake at 8; and American Brake Shoe at 17. The broker soon learns where the securities are dealt in, and automatically turns in the right direction whenever he has occasion to trade. A table situated in one corner of the room gets considerable attention, because here the "loan crowd" gathers to borrow and lend money. These operations are explained in later chapters. Still another portion of the floor on a raised platform, under a gallery, is given up to bonds; and on one side of the room, close to the cable instruments, are the "arbitrage" brokers who buy from, and sell to, foreign brokers.

Brokers tend to gather in crowds. Around or near each post are several of these crowds, which naturally vary in size as the popularity of the various securities changes. Thus, one hears such expressions as the "Steel Crowd," the "Reading Crowd," and so on.

7. *Method of purchase and sale of securities.*—To the average visitor, who is permitted to make the rounds of the Stock Exchange, the whole affair is a puzzle. He does not understand what takes place on the floor, and he leaves the place with wonderment. Altho pandemonium seems to exist, the machinery of

business runs so smoothly that to the layman it is incredible that transactions involving hundreds of millions of dollars are carried thru without a hitch every day.

When a member secures an order to buy he goes to the proper post where the security is dealt in, and calls out how much he desires to buy and the price he is willing to pay. The price named will of course be at the last "quotations" or below it. The brokers who have that stock for sale gather around the post, each shouting out the price at which he is willing to sell. At first the buyer and the sellers may be far from a common ground of agreement but gradually they approach each other until some broker offers the stock at the price which is agreeable to the buyer.

The first bid and offer to buy or sell takes precedence, when it can be heard, and if there is a dispute as to which particular bid or offer was first, an arbitration committee decides. Prices of stocks are made by eighths of one dollar, never less. The fractions are one-eighth, one-quarter, three-eighths, one-half, five-eighths, three-quarters, and seven-eighths; no other fractions are used. An eighth, of course, is the equivalent of twelve and one-half cents. Stocks are also spoken of as rising or falling one or two or any number of "points." A point is one dollar unless the stock happens to be selling at less than a dollar, in which case a point would be one cent.

In the process of bidding and asking above de-

scribed, the seller finally offers a price that is agreeable to the buyer. The latter shouts "Take it," and each makes a simple memorandum upon a little pad which he carries in his hand, as to the number of shares "bought" or "sold," as the case may be, the price, the name of the security and the name of the broker with whom the deal is closed.

It must be understood that no stock certificates or bond certificates ever appear on the floor. They are not transferred or delivered there. The only business which takes place on the Stock Exchange is that of making contracts to buy and sell securities and arrangements for the lending and borrowing of money and stocks; the actual delivery and payment always takes place elsewhere. These contracts are commonly known as "sales." They are also called "transactions," or "dealings." The total sales of any one stock or of all stocks, in any given period of time, is known as the "volume." Newspapers, tickers and all other reporting agencies properly take one side of the account only in adding up the total, altho for every buyer there is a seller and for every seller, a buyer.

A Stock Exchange firm may have a score of broker partners only one of whom is a member of the Stock Exchange. The partners who are not members would no more be admitted to the floor than an outsider. This fact cannot be too strongly emphasized. For example, the firm of J. P. Morgan & Company belongs to the Stock Exchange, but only those of the

dozen partners who hold seats would be admitted to the floor.

Orders to buy or sell securities are communicated to the brokers by means of private telephones already referred to. Their attention is called to their telephones by means of a simple device; each member has a number high on the wall of the floor room usually covered by a disk, and when any one in his office wants to give him an order, a telephone operator at the Exchange presses a button which drops the disk and reveals the number. The broker who is constantly on the watch is thus notified. He does not even need to leave the floor to go to his telephone, perhaps fifty feet away, for there are hundreds of messenger boys who dart to and fro between brokers on the floor and the clerks who operate the telephones. Thus brokers can get into touch with their partners, customers and offices almost instantaneously, and without leaving the floor at any time.

The brokers usually gather about 9.30 A. M. The Exchange opens for business at 10 A. M., at the ringing of a bell, and closes at 3 P. M., except on Saturday, when it closes at noon. There is usually a rush of orders to execute at the "opening," which means the first few minutes after ten o'clock, and the "tone" of the market at the opening is considered important.

8. *Number of trading members.*—Not all of the eleven hundred members of the New York Stock Exchange are traders on the floor of the exchange.

Among this number are some of our greatest capitalists. A great many members employ other brokers to do their buying and selling of securities for them. Because of the large volume of transactions in the course of a year, the reduction which they save in the way of cheaper commissions more than offsets the interest on the money invested in their seats. The active members upon the floor do not average over seven hundred in number.

9. *Classes of brokers.*—After one becomes a member of the exchange he finds that there are several methods of doing business open to him. As a general rule a member selects one of these various classes but he may extend his operations to any or all of the others. We will now discuss these various classes.

10. *Commission brokers.*—The most common type of broker who, either alone or in partnership with other brokers, devotes the greater part or the whole of his time to the execution of orders for buying or selling for customers is called a commission broker. He or his firm, if he is a member of a commission house, receives a commission the amount of which depends on the selling price of the securities as previously shown. His purpose is to execute customers' orders as promptly as possible. He maintains offices and large forces of employes in order to render efficient service to customers, for by giving satisfaction to customers he builds up a larger business.

Very often the commission brokers have so many

accounts and so many customers that it is impossible for them to execute all their orders. This is especially the case when the market is active. At such times they may employ what are known as "two-dollar" brokers.

11. *"Two-dollar" brokers.*—There are about two hundred and fifty of these "two-dollar" brokers who execute orders for commission brokers and other members. In the past they received $2 commission for every hundred shares as compared with $12.50 received by the commission broker, hence this name. We have already seen that the commissions are now higher than those charged prior to May 8, 1919, and are based on the selling prices of securitities. The "two-dollar" broker's commission now amounts on the average to about $2.50 per one hundred shares, as the selling prices of most stocks range between $10 and $125 per share. The reader should refer again to the section on commissions for the complete schedule of commissions.

At first glance it would seem strange that any broker should take the trouble to execute orders for other members at this rate, when he could get a much higher rate for doing the same amount of work for outside clients. There are, however, a considerable number of brokers who do not care for a business that involves a large number of negotiations and accounts with customers and the maintenance of a more or less expensive establishment, but who would rather execute the floor business of other members who have a large

clientele. It is obvious that because of the low rate of commission that these men charge for performing this function, they must transact a large volume of business in order to secure a fair amount of profit. Reliance on efficiency and celerity in the execution of orders is their means of securing business and the proficiency they display, especially during periods of activity, is often astonishing.

12. *Odd-lot brokers.*—Odd-lot brokers are, as the name implies, dealers in odd or fractional share lots. Any number of shares less than one hundred is considered an odd lot as the unit of trading is one hundred. It is impractical to have a smaller trading unit, such as ten shares or one share, because of the large volume of business transacted on the floor of the exchange. In an active market, it would be practically an impossibility to execute orders as large as five hundred shares or more and especially if a broker were required to make contracts with all who should offer to buy or sell small lots irrespective of how many shares there were in any bid or offer. To have a smaller unit of trading than one hundred shares would be also a tremendous inconvenience to bankers. It would necessitate the employment of an army of clerks to lend money on collateral consisting of hundreds of certificates of different, odd amounts. Nevertheless, there are millions of individuals who own less than one hundred shares, and this is only made possible by the odd-lot broker.

There are about fifty of these odd-lot brokers doing

business, but it should be remembered that even tho the outside individual purchases less than one hundred shares of a particular stock he does not do his buying directly thru the odd-lot broker. He places his order with a commisssion broker the same as he would if he were buying an even number of hundreds of shares but the commission broker in this event buys the fractional number of shares from an odd-lot broker.

The business of the odd-lot broker is that of buying from and selling to commission brokers shares numbering from one to ninety-nine and he has no dealings with the outside public. He puts these small lots together to complete share certificates or he will split up a one hundred share certificate as the case may be. It can readily be seen that the odd-lot broker has an enormous amount of detail work which means heavy expenses. Therefore to purchase an odd lot of stock it costs the outsider one-eighth or twelve and one-half cents a share more than the price of the last hundred share lot traded in, and to sell he will also receive a price one-eighth less. This is because the odd-lot broker sells to the commission broker at a price one-eighth higher than the market price for one hundred shares. When the odd-lot broker has sold odd lots amounting to one hundred shares of a particular stock he will then buy one hundred shares to split up and deliver on his sale contracts. Also the odd-lot broker when he buys odd lots does so at a price one-eighth less than the market price. He then groups and sells

the shares in one hundred share lots at the market price. The profit he derives is the difference between his buying and selling prices as he does not charge any commission for his services.

When selling fractional share lots the odd-lot broker sells short and later buys in hundred share lots to cover. It is necessary for him to sell short because he cannot know in advance what the amount of his sales will be in any given stock.

To buy first and later sell would be a very unprofitable method of operating for such a trader. The only protection he has against loss is to be able to sell short and later buy when he has sold one hundred shares of a particular stock. It is quite evident that short selling makes possible trading for the odd-lot broker and without it there would be no market for the small investor. It has been estimated that the odd-lot broker transacts about one-fifth of the business done on the floor of the Exchange. It always happens that there is a greater volume of odd-lot buying during severe declines in the market. At such times the small investor takes advantage of the lower prices.

13. *Specialists.*—Specialists are those brokers who specialize in selected securities. In some cases they study and give their attention to simply one security but in most instances three or four securities occupy their attention. Their business is transacted mostly with other brokers and under no circumstances do they deal with the outside public. Their existence is es-

sential to the commission broker as they are always ready to make a market for him. When executing orders in inactive securities the commission broker employs the specialist. These specialists are supposed to know the last price of the securities of their particular specialties. The stocks to which a specialist devotes his attention are generally well known to the other brokers. These men center themselves where their particular specialties are traded in and are ready to fill all orders. It is true that without the specialist there would be no market for many securities. Besides filling orders for commission brokers the specialist often trades on his own account; otherwise there would be an insufficient market. In this way he creates a market which without him might not exist. The specialist's economic usefulness can readily be understood when we consider that he is willing to take a chance as a speculator and is ready to trade under all circumstances; this also makes more certain the business of the commission broker. He helps to create an ever-ready market in the securities in which he specializes and prevents the wider fluctuation that otherwise would be very likely to prevail between transactions.

14. *"Floor" or "room" traders.*—Floor or room traders are those who trade independently on their own account. They are unlike any other class of traders in so far as they do not carry on any transactions for others. They speculate not with the idea of making a large profit on any one transaction but for

the purpose of "scalping" "eighths" or "quarters" and depending upon doing a large volume of trade to net them an adequate income. These traders are on the floor of the exchange at all times and are able to buy and sell and take advantage of every slight fluctuation up or down. They will one moment be "short" of a security and the next "long," changing their position whenever in their judgment a small profit can be made. If one finds his judgment wrong he will be quick to shift his position to limit the loss, but if he has acted correctly he is quite satisfied with a small profit. Floor traders expect to lose on some of their transactions and do as a matter of fact, but their aim in the long run is to be able to make a larger number of profitable transactions. To do this they usually specialize in a few stocks and, as far as possible, endeavor to keep from being caught in any general movement of prices. In order to use as little cash as possible to settle their transactions they try each day to even up their sales and purchases. This so-called "evening up" of transactions is also done by many so they may "go home with nothing to disturb them." There are possibly one hundred of these room or floor traders whose existence helps to make more of an ever-ready market, even tho their purpose for trading is for no other reason than the shaving of small profits.

15. *Arbitrageurs.*—Before the Great War another class of traders considerably in evidence were the arbitrageurs. These were for the most part wealthy

international banking houses who made a profit by arbitraging which consisted of taking advantage of the divergence in the prices for the same stocks in different markets.

The principle of arbitraging is very simple, the practice beset with so many complications that it can be operated only by the most experienced traders. A few considerations will make this clear. Suppose the price of a given stock in city A is 87 and in B at the same time is 88. It is obviously profitable to buy the stock in A and sell it in B provided the costs of the operation do not eat up the entire margin of profit.

The spread between the price of the stock in the two cities in these days of telegraphic communication is never likely to be large and if such transactions as are described above are to be made safely there must be the possibility of almost instant communication by telephone, telegraph or cable between the two points. Otherwise a slight shift in the prices of the stock might turn a prospective profit into a loss.

At one time there was considerable business of this nature between New York and other exchanges in the United States but it was discountenanced by the Stock Exchange authorities and regulations adopted regarding the transmission of quotations which made it impossible. Before the Great War it was carried on extensively between New York and London and to some extent with continental exchanges. At the present time it has almost entirely ceased tho there

are some who are of the opinion that if there is a return to normal exchange relations it will be revived.

Apart from adverse regulations of the Exchanges in New York and London and the hostile attitude of the British Government this business would have fallen to pieces during the war period thru the restrictions upon the use of code messages in cables, and the fact that private individuals were unable to secure prompt cable service. In the days before the war, with rapid cable messages, transactions of this nature were frequently closed out in fifteen minutes and often in less time. When the time for cable transmission lengthened into hours the basis for the business was swept away.

Some of the technical points in the process as it was formerly carried on may be noted. London quotes stocks at a fixed rate of exchange $5 to the pound sterling. If for example Union Pacific were quoted at $175 the actual purchase price would be £35. To determine the cost in London to a purchaser in New York the rate of exchange enters into the calculation. If the rate were $4.85 the New York equivalent would be 168¾. Equivalents are ascertained very rapidly by use of conversion tables.

If, with a London quotation equivalent to 168¾ in New York, the New York quotation were 168, the arbitrageur would see an opportunity to make a profit.

16. *London jobbers and bankers.*—When a person becomes a member of the New York Exchange he

may according to his liking trade as any one or more types of brokers we have discussed. This breadth of choice is not possible when one becomes a member of the London Stock Exchange. There a member can only belong to one of two classes, either broker or jobber, which class he must indicate at the time he joins the Exchange.

A London broker's business is restricted to buying or selling for the public and he executes his orders thru the jobber. He is in reality a middleman between the public and the jobber, the jobber dealing only with brokers and other jobbers. When a London broker gets an order from a customer he goes to a jobber on the floor of the exchange who specializes in that security. He does not need to indicate to the jobber whether he wishes to buy or sell. However, it may hasten the conclusion of the transaction if the broker discloses what he wishes to do. If the jobber is shrewd he will endeavor to guess what the broker's wishes are and name his prices accordingly. The jobber is expected to name two prices, that for which he will sell and the other at which he will buy. He is then obligated to buy or sell to the broker at the price named, up to a certain limit known as the "jobber's limit," which varies and is limited according to the price of the stock. If the jobber's price is not agreeable the broker will tell him to "come closer." The jobber may for example name a price of 100¼ for buying and 100⅝ for selling and the broker then insists on a closer price which in such an instance may

induce the jobber to make his prices 100⅜ and 100½ or still closer if he wishes since price variations on the London exchange are quoted in fractions as low as sixteenths. If the broker still finds the jobber's price is unsatisfactory he may then try to strike a bargain with some other jobber. After the broker has made a transaction he will notify his customer of the particulars and disclose to him the name of the jobber from whom he bought. The London broker occupies a position similar to that of our commission broker; he deals directly with the public.

It should be mentioned here that in order for the jobber to conduct his business he sells short and then immediately buys the stock to cover his transaction. On the other hand when he buys a security he immediately endeavors to dispose of it at a profit. The jobber makes his profit from what is known as the "jobber's turn" which is nothing more than the difference he makes between his buying and selling prices.

We may compare the jobbers to our specialists, to our odd-lot broker and to our room trader. But in reality he is more than all these; he is the market himself since he makes the market. The broker must do all his buying and selling thru the jobber, whereas the jobber trades with the broker and his fellow-jobbers, therefore the jobber is the only one who furnishes quotations.

From the viewpoint of the American the London system of trading seems to be "beating around the

bush." However, because there are a great number of little known foreign securities on the London Exchange and so many more shares of small domestic companies than on the New York Exchange, it is quite possible that such a complete system of specialists, rather than the more open and general system of the New York Exchange, is necessary. This basis for the system is often cited in its defence. W. P. Hamilton, editor of the *Wall Street Journal,* who is of English birth and training, is quoted in the "Work of Wall Street" as saying:

> There are difficulties in connection with the collection of prices in London which people used to New York Stock Exchange methods do not appreciate. Actual sales are not recorded there. The prices at which a few transactions have been made are marked on the official list, but there is no means of telling whether the market has dealt in 5,000 shares or 500,000 during the day. The London ticker only quotes bid-and-asked prices, and never records the price at which any particular transaction was done.
>
> Under the rules of the London Stock Exchange, the quotation of a price by one member to another binds the member who quotes to buy 100 shares at his bid price, or sell 100 shares at his asked price, if the other member chooses to trade. This has the effect of securing a really close bid-and-asked price. It is also the reason why an arbitrage house will know the London market price better than any news agency can.
>
> The London system has its advantages and its disadvantages. In our market the jobber's turn is saved, but, in an excited and feverish market, the broker may be hours before he can trade at all. In London, he is always sure of being able to sell at some price or buy at some price—both very important conditions in a panicky market, when it

often happens here that the broker has to offer the stock down indefinitely until he finds a purchaser. In the May panic of 1901, Jersey Central was offered down here from 153 to 102 and the next transaction was 148. This would have been impossible in London. The jobber might have been able to sell for his customer at worst within five points of the previous quotation.

REVIEW

What is the legal status of the New York Stock Exchange?

Explain fully the nature of a seat on the Exchange.

What are the requirements before one may become a member of the Exchange?

Describe the interior of the New York Stock Exchange.

How is the Exchange governed?

Distinguish between the different classes of brokers according to their methods of trading.

CHAPTER IV

STOCK EXCHANGE SECURITIES

1. *Securities listed.*—It would be an impossible task to enumerate the various securities that are listed on the New York Stock Exchange. Let it be sufficient for us to note that they consist of a variety of different types of stocks and bonds a classification of which will be found in the Modern Business Texts on "Corporation Finance" and "Investments." If we refer to a daily newspaper we find a list of securities sufficiently complete for all practical intents and purposes. One will further observe by glancing at the market news of the daily papers that certain stocks are known by generic terms. For example, the term "rails" means the entire group of railroad stocks; "industrials" refers to nearly all other stocks. Certain railroad stocks are sometimes designated by such terms as "coalers," their principal source of income being derived from freight traffic in coal; "grangers" are the roads which run thru the grain-growing parts of the country, their principal item of freight being grain. Such terms as the "Goulds," "Vanderbilts," "Harriman" and others are named after the founder of the system of which group they are a part; and "tractions" refers to our street railways.

Industrial stocks are designated by such groups as the "steels," "rubbers," "oils," "coppers," etc. Certain stocks are known by abbreviated and familiar terms such as "Can" for American Can Company; "Sugar" for American Sugar and Refining Company; "Motors" for General Motors Corporation; "Erie," "Central," "Union," "St. Paul" and so forth. Other stocks are known by nicknames, such as "Nipper" or "North Pac" for "Northern Pacific"; "Mop" for Missouri Pacific; "Katy" for Missouri, Kansas & Texas, and so on.

Most stocks of large corporations which have a rather wide distribution of ownership are listed on the Stock Exchange. This includes most of the great interstate corporations. Stocks which are closely held will not be listed on the Exchange, nor are corporations often listed during their period of infancy, irrespective of their large capitalization. The Exchange would rather leave such stocks to the curb market, preferring not to list stocks until they are at least a year old.

It has only been within recent years and due to the Great War that attention has been directed to foreign securities. Prior to the war very few foreign securities were listed on the New York Stock Exchange. This was primarily due to the fact that very little American capital was available for them and, furthermore, investors were not interested in them. More recently several new securities of foreign origin have been admitted by the Board. In the past the

New York Stock Exchange has differed from European exchanges in this respect. The London Stock Exchange is the prime example where thousands of foreign securities have been actively traded in for many years.

2. *Stock and bond quotations.*—Stock prices are quoted for hundred share lots and multiplies thereof in dollars and fractional parts of a dollar.

The daily newspapers usually give on their financial page the opening price of a stock which is the price paid on the first transaction in that particular security. The high, low and closing prices paid are next given. The column headed net change is often misunderstood. The net change (minus or plus) indicates the difference between the closing price of the preceding day and the present closing price.

3. *Bond quotations.*—Bond prices are mostly quoted on a percentage basis. It is necessary to know the par value of a bond before one is able to arrive at the money equivalent of the quotation. A bond quoted at 98 means ninety-eight per cent of its par value, whatever that may be. It may be a bond of a $1000, $500, $100 or $50 par value, therefore the quotation may mean $980, $490, $98 or $49. The most common par value of bonds is $1000. The prices quoted for bonds are usually for $1000 units. Thus a price of 80 means that the bond is selling at $800 whereas a price of 79¼ means $792.50. The only exception to this method of quotation is Liberty Bonds. In this case percentages are used all the way

thru instead of the customary 1/8. Thus a Liberty Bond at 91.62 means $916.20 for a $1000 bond.

A bond quotation does not necessarily indicate the full price which must be paid as does a stock quotation. In addition to the price equivalent to the quotation the purchaser pays the accrued interest, that is, the interest which has been earned on the bond from the last interest payment date up to the date of sale.

4. *Par value.*—Considering the par value of stocks, the most common denomination is $100 a share. In many instances, however, the par value of some of our most important corporations is $50, for example, Pennsylvania Railroad, Lehigh Valley, Reading, Delaware, Lackawanna and Western, United Gas Improvement Company, Lehigh Coal & Navigation, Midvale Steel & Ordnance, etc. Other corporations, principally copper stocks, have a par value of $25; and in the mining stocks we find instances of par values varying from $5 to $1 and even as low as one cent a share. The laws of most states provide that a stock may have any par value. In a very few cases we have corporations with par values as high as $1000. Usually when a corporation has more than one kind of stock the par value is uniform. Recently many concerns have issued stock with no par value, such as American Ship and Commerce, Cerro de Pasco Copper, Chalmers Motor, Chandler Motor, Coca Cola, Consolidated Textile, Cosden, Cuba Cane Sugar, Famous Players-Lasky, General Motors, B. F. Goodrich, Kennecott Copper, Loews,

Inc., Lofts, Inc., Pierce Arrow Motor, Replogle Steel, Republic Motor Truck, Saxon Motor, Sinclair Consolidated Oil, Stewart Warner Speedometer, Stromberg Carbureter, Stutz Motor, Submarine Boat, Transcontinental Oil, Union Oil, United Retail Stores, Willys Corporation, Wilson and Company, and others.

Quite often too much significance is placed on the par value of a stock. It should be remembered that stocks represent nothing but a share or percentage in ownership of a corporation and to give them a nominal value is apt to be misleading. This is not the case with bonds as they are promises to repay definite sums of money, whereas, a stockholder is a part owner or partner of a corporation and is simply entitled to share in the dividends. The par value of a stock does not indicate its real value, but there has been a tendency in the past to ignore this fact. Many have the idea that a stock must have back of it value equal to its par value and that it represents a claim against the corporation for the amount of its face. There is the inclination to think that because a stock has a par value of $100 it is practically a guarantee that it represents that amount of value; such is not the case. There is, however, in the opinion of some authorities, a very good reason for giving shares a par value because it furnishes a standard by which the stock can be measured. When the price declines below par, the holder is apt to take warning and ascertain the reasons for the movement. In this way an

index of the business standing and activities of the corporation is provided. Advocates of the non-par principle claim there is no really good reason for such a standard as the value of a stock is simply a question of the management and success of the company, which is reflected in the earnings on its common stock.

The common stock of a corporation represents the speculative element of the business and therein lies both the risk and compensative feature. The preferred stocks and bonds ordinarily represent the foundation of the business and an investment in them is more secure. Up to the present time no company has issued a preferred stock without a par value, but on the other hand a number of companies have issued non-par common stock and also preferred stock with a par value. Thus the distinguishing characteristic is so evident that the least informed cannot help but take heed.

The following is an excerpt from the findings of the Railroad Securities Commission appointed by President Taft, during his tenure of office, which strongly favors the elimination of the par value as a cause of confusion to investors:

> We do not believe that the retention of the hundred dollar mark, or any other dollar mark, upon the face of the share of stock, is of essential importance. We are ready to recommend that the law should encourage the creation of companies whose shares have no par value, and permit existing companies to change their stock into shares without par value whenever their convenience requires it. After such conversion any new shares could be sold at such price

as was deemed desirable by the board of directors, with the requirement of publicity as to the proceeds of the sale of such shares and as to the disposition thereof; giving to the old shareholders, except in some cases of reorganization or consolidation, prior rights to subscribe pro rata, if they so desired, in proportion to the amount of their holdings.

As between the two alternatives of permitting the issue of stock below par, or authorizing the creation of shares without par value, the latter seems to this Commission the preferable one. It is true that it will be less easy to introduce than the other, because it is less in accord with existing business habits and usages; but it has the cardinal merit of accuracy. It makes no claims that the share thus issued is anything more than a participation certificate.

5. *Listing of securities.*—A listed security as distinguished from an unlisted security, is one which has the right to be dealt in on the floor of the Exchange. This privilege is granted because certain definite requirements have been met and approval given by the Exchange authorities. The Exchange is as particular about the placing of securities upon its list as it is about the admission of members. The requirements for listing securities are rigidly enforced but after a corporation has procured admission to the stock list, supervision by the Exchange is less rigid.

Many persons are of the opinion that listed securities have greater merit than those not listed and for that reason have been admitted to trading on the Exchange while others have been denied admission because of not being able to meet the requirements. There are, however, many securities not listed which are considered fully as desirable from the investor's standpoint. It is not to be assumed that only listed

securities have real value. This would be far from the truth, for listed securities are of a wide variance, some being of the highest grade while others are practically valueless. The mere fact that a security is listed does not necessarily prove it to be of real value. It may be either unsafe or undesirable, for a corporation after being listed may drift into an unsatisfactory condition without objection being raised by the Exchange and its securities may drop from a high grade to a practically worthless basis. The Stock Exchange assumes no responsibility and affords no guarantee of the value of any security which is admitted to trading on its floor. It is up to the investor to make his own decision as to the value of the securities he buys and sells, for the Exchange neither recommends nor condemns a security. Neither does it make any endeavor to influence the management of a corporation nor cause the prices of securities to bear a harmonious relationship to their intrinsic value. On the other hand, in the greater number of instances, the companies whose securities are listed must be sufficiently important and old enough to furnish the most exhaustive information which the Exchange requires at the time of listing.

When a stock or bond is listed the Exchange endeavors to procure from a company all the information that can be reasonably and humanly obtained. Rarely ever have the facts presented been found to be false, but the Exchange assumes no responsibility for the information given. It may be said concerning

listed securities that the investor has all the available facts upon which to form an opinion. In many cases, however, companies whose stocks and bonds are listed have been ruined by manipulation or mismanagement; but even in these cases the companies have had enormous amounts of actual property, and have not been patently fraudulent schemes, mere paper projects, such as are offered literally by the scores of thousands to the investor outside of the Stock Exchange.

6. *Exchange requirements.*—The examining of all applications for the listing of securities on the Stock Exchange is made by a Committee on Stock-List. The constitution of the Exchange provides that this committee shall consist of five members of the Exchange. They employ a high-salaried clerk, in reality an important expert with a staff of assistants, to study the reports and go over them in minute detail.

An application must conform to the requirements made by the Exchange and must be signed by an executive officer, authorized to do so, of the corporation making application.

The following is a summary of the listing requirements taken from the "The New York Stock Exchange," a book written by H. S. Martin, Secretary of the Exchange:

7. *The history of stocks.*—An application for the listing of securities upon the Exchange must conform to the

Requirements, and must be signed by such executive officer of the applying corporation as has been specifically authorized to do so; the application is therefore the act of the corporation.

Every application for an original listing of capital stock shall recite:

A. Title of corporation.

B. (1) Date of organization; (2) name of State authorizing incorporation.

C. (1) Duration of charter; (2) and of charters of constituent, subsidiary, owned or controlled companies.

D. (1) History of corporation; (2) if a consolidation, merger or reorganization, history of predecessor, and constituent, subsidiary, owned or controlled companies, or firms, showing (a) names, location and stock issue; (b) conditions leading to new organization.

E. (1) Charter rights: (2) nature of business, character and amount of annual output, number of employes; (3) special rights or privileges granted directors by charter or by-laws.

F. (1) Whether capital stock is full paid; (2) nonassessable; and (3) if personal liability attaches to shareholders.

G. (1) Issues, dividend rate and par value; (2) total amount of each, authorized and issued; (3) increases and authority therefor, including (a) action by stockholders, (b) by directors and (c) by public authorities, etc.; (4) amount unissued, (a) options or contracts on same, (b) specific reservation for conversion.

H. If preferred stocks: (1) Whether cumulative or noncumulative; (2) preferences, including (a) voting power; (b) dividends; (c) distribution of assets on dissolution or merger; (d) redemption.

I. Voting power of obligations of debt.

J. (1) Dividends heretofore paid; (2) by predecessor, or constituent, subsidiary, owned, or controlled companies.

K. Description of property: (1) owned in fee; (2) controlled; (3) leases; (4) franchises; (5) location, nature,

and acreage; (6) railroads, mileage completed, operated and contemplated, and trackage rights; (7) traffic agreements; (8) equipment; (9) character of buildings and construction; (10) timber, fuel or mining lands, water rights (see paragraphs T. to Z. below).

L. (1) Purpose of issue; (2) application of proceeds; (3) amount of issue for securities, contracts, property, description and disposition of securities acquired; additional property acquired or to be acquired, with particulars, as required by paragraph K.

M. (1) Mortgage, and (2) other indebtedness, (a) date of issue, (b) maturity, (c) interest rate, (d) redemption by sinking fund or otherwise; (3) similar information regarding mortgage and all indebtedness of constituent, subsidiary, owned, or controlled companies.

N. Other liabilities, joint and several: (1) guaranties, (2) leases, (3) traffic agreements, (4) trackage agreements, (5) rentals, (6) car trusts, etc., (7) terms of each, and provision for payment.

O. Fiscal year.

P. Financial statement: (1) earnings for preceding five years if available; (2) income account of recent date for at least one year; (3) balance sheet of same date; (4) similar figures for precedessor, constituent, subsidiary, owned or controlled companies; (5) final balance sheet; (6) when reports published; (7) for corporations consolidated within a year, income account and balance sheets of all companies merged and balance sheet of applying corporation.

Q. Names of (1) officers; (2) directors (classified) with residence; (3) transfer agents, and (4) registrars, with addresses.

R. Location of principal and other offices of corporation.

S. Place and date of annual meeting.

In addition to the above, corporations which are owners of mines must recite:

T. Patented and unpatented claims, by numbers.

U. (1) A geological description of the country; (2) location and description of mineral and other lands; (3) ore

bodies; (4) average value of ore; (5) character; and (6) proper methods of treatment.

V. History of prior workings, showing (1) results obtained; (2) production each year.

W. (1) Ore reserves compared with previous years; (2) estimate of engineer as to probable life of mines; (3) probabilities by further exploration.

X. (1) Provisions for smelting and concentration; (2) cost of (a) mining, (b) milling and smelting, (c) transportation; and (3) proximity of property to railway or other common carrier.

Y. Income account: (1) receipts; (2) expenditures; (3) disposition of income.

Z. Properties in process of development: if income not available, what guaranties for working capital and for completion of development.

8. *History of bonds.*—An application for an original listing of bonds shall recite all information required for listing capital stock, and

A. (1) Amount, denominations and numbers; (2) full title; (3) amount authorized and outstanding, authority therefor, including (a) action by stockholders, (b) directors, and (c) public authorities, etc.; (4) whether bonds are coupon (régisterable as to principal) or registered, interchangeable or exchangeable; (5) exchangeability or convertibility into other securities, and terms.

B. (1) Date of issue and maturity; (2) interest rate; (3) places at, and dates for payment of interest and principal; (4) where registerable or transferable; (5) kind and standard of money, and options; (6) tax exemption; (7) whether redeemable or purchaseable in whole or in part, showing (a) dates, (b) price, (c) duration of published notice, (d) disposition of redeemed or purchased bonds.

C. Mortgage or indenture provisions for (1) serial issues; (2) values in United States gold coin; (3) issuance in foreign languages and (4) that the English version governs; (5) terms of exchangeability of bonds payable in foreign places for bonds payable in United States.

D. (1) Security-Mortgage, indenture of trust, or other agreement; and, (2) liens; (a) properties covered, (b) mileage of railway lines, (c) buildings, (d) equipment, (e) securities; (f) rights, (g) privileges, (h) titles, (i) franchises, (j) leases, etc.; (3) other liens covering same or any part of same properties; (4) guaranty and terms.[1]

E. (1) Names and addresses of trustees, and any unusual additions to or limitations of powers; (2) provision for declaration of principal due and payable in event of default of interest or other default, and waiver; (3) percentage of outstanding bonds controlling trustee.

F. Purpose of issue and application of proceeds, similar to that called for by Paragraph L. of the Requirements for Listing Stock.

G. Disposition of bonds refunded and mortgage securing same.

9. *Agreements.*—For incorporation in applications:

A. Not to dispose of its stock interest in any constituent, subsidiary, owned or controlled company, or allow any of said constituent, subsidiary, owned or controlled companies to dispose of stock interests in other companies unless for retirement and cancellation, except under existing authority or on direct authorization of stockholders of the company holding the said companies.

B. To publish at least once in each year and submit to the stockholders, at least fifteen days in advance of the annual meeting of the corporation, a statement of its physical and financial condition, an income account covering the previous fiscal year, and a balance sheet showing assets and liabilities at the end of the year; also annually an income

[1] The requirements for listing additional amounts and for listing certificates of deposits and voting trust certificates are not recited, being of insufficient interest in this connection and very similar to those for original application. They cover practically the information called for above, but of course, not to so full an extent.

account and balance sheet of all constituent, subsidiary, owned or controlled companies.

C. To maintain, in accordance with the rules of the Exchange, a transfer office or agency in the Borough of Manhattan, City of New York, where all listed securities shall be directly transferable, and the principal of all listed securities with interest or dividends thereon shall be payable; also a registry office in the Borough of Manhattan, City of New York, other than its transfer office or agency in said city, where all listed securities shall be registered.

D. Not to make any change in listed securities, of a transfer agency or of a registrar of its stock, or of a trustee of its bonds or other securities, without the approval of the Committee on Stock List, and not to select as a trustee an officer or director of the company.

E. To notify the Stock Exchange in the event of the issuance of any rights or subscriptions to or allotments of its securities and afford the holders of listed securities a proper period within which to record their interests after authorization, and that all rights, subscriptions or allotments shall be transferable, payable and deliverable in the Borough of Manhattan, City of New York.

F. To notify the Stock Exchange of the issuance of additional amounts of listed securities, and make immediate application for the listing thereof.

G. To publish promptly to holders of bonds and stocks any action in respect to interest on bonds, dividends on shares, or allotment of rights for subscription to securities, notices thereof to be sent to the Stock Exchange, and to give to the Stock Exchange at least ten days' notice in advance of the closing of the transfer books or extensions, or the taking of a record of holders for any purpose.

H. To redeem preferred stock in accordance with the requirements of the Stock Exchange.

I. To notify the Stock Exchange if deposited collateral is changed or removed.

10. *Trustees of mortgages.*—The Committee recommends that a trust company or other financial corporation be ap-

pointed trustee of mortgages, indentures, and deeds of trust; and when a State law requires the appointment of an individual as trustee, a trust company or other financial corporation be appointed as co-trustee.

Each mortgage, indenture, or deed of trust should be represented by a separate trustee.

The Committee will not accept as trustee:

(a) An officer or director of the issuing corporation;

(b) A corporation in which an officer of the issuing corporation is an executive officer.

The trustee shall present a certificate accepting the trust and certifying (1) securities are issued under the terms of the mortgage or indenture, giving the numbers and amount certified; (2) collateral is deposited; (3) disposition of prior obligations. For additional issues of bonds, the trustee must certify that (1) increase is in conformity with terms of mortgage or indenture; (2) additional collateral deposited; and (3) disposition of prior obligations.

The company and trustee shall notify the Stock Exchange of the holding, cancelation, or retirement of securities, by redemption, thru the operation of sinking fund or otherwise.

The trustee must notify the Stock Exchange if deposited collateral is changed or removed, and furnish list of collateral substituted.

A change of trust shall not be made without the approval of the Committee.

11. *Transfer and registry.*—Every corporation whose securities are listed upon the Stock Exchange must in accordance with the rules of the Exchange, maintain (a) a transfer office and (b) a registry office, both in the Borough of Manhattan, City of New York. The transfer agency and registrar shall not be identical, and both must be acceptable to the Committee. A company cannot act as registrar of its own stock.

Where a stock is transferred at the company's office, the transfer agent or transfer clerk shall be appointed by specific authority of the board of directors to countersign certifi-

cates in said capacity, and shall be other than an officer who is authorized to sign certificates of stock.

The entire amount of the capital stock of a corporation listed upon the Stock Exchange must be directly transferable at the transfer office of the corporation in the Borough of Manhattan, City of New York. When a corporation also makes transfer of its shares in other cities, such certificates shall be interchangeable, and identical in color and form, with the New York Certificates, except as to names of transfer agent and registrar; and the combined amounts of stocks registered in all cities shall not exceed the amount authorized to be listed.

Interchangeable certificates must bear a legend reciting the right of transfer in New York and other cities.

The registrar must file with the Secretary of the Stock Exchange an agreement to comply with the requirements in regard to registration and not to register any listed stock, or any increase thereof, until authorized by the Committee.

Certifications of registry must be dated and signed by an authorized officer of the registrar.

A change in the form of a security, of a transfer agency, or of a registrar, shall not be made without the approval of the committee.

After the Listing Committee has passed favorably upon an application to list securities, it is referred to the Governing Committee, with the Committee on Stock-List's report giving a full statement of the capital, number of shares, resources, etc. The Governing Committee reviews the evidence and if it gives its consent the security may then be listed on the Exchange for trading. Thus, before a security is admitted to the stock list it must be approved by two committees, one of which is the supreme body in the government of the Exchange.

12. *Protection to investors.*—We have said that after a security is listed supervision of the Exchange virtually ceases. It would be incorrect to state, however, that the Stock Exchange exercises no supervision. On the other hand, the Stock List Committee has for many years recommended "to the various corporations whose securities are here dealt in, that they shall print, publish and distribute to stockholders, at least fifteen days prior to annual meetings, a full report of their operations during the preceding fiscal year; together with complete and detailed statements of all income and expenditures, and a balance sheet showing their financial condition at the close of the given period. The Exchange requests that stockholders of the several corporations take such action as may be necessary for the accomplishment of this recommendation." Today the Exchange "requires" that all corporations do this. The publicity which is the result of this requirement is a benefit to the investor because it enables him to determine for himself the merits of a security.

Furthermore proper notice must be given of all dividends, new stock issues and other essential details. A long list of rules and regulations of the Exchange are rigidly enforced by the Exchange, which endeavors to prevent anything in the nature of actual fraud in the issue of stock, forged stock, illegal issues, improperly engraved certificates, over-issues of stock and other fraudulent measures. The Board requires all companies to maintain in the city of New York

two separate offices a transfer office where the securities are made directly transferable, and where the principal of all listed securities with interest or dividends are made payable; also a registry office where all listed securities shall be registered. This is to prevent all possible delay or fraud in transferring securities to the name of a new owner.

While the Exchange practically guarantees freedom from the grosser forms of fraud in its securities, it does not guarantee their worth. To do the latter the Exchange would be undertaking one of the biggest tasks and burdens in the whole of our modern business life, and one which would be practically an impossibility to execute and carry out.

13. *Advantages of listing.*—The listing of a security on the New York Stock Exchange gives it a broad active market which obviously increases its marketability. It would be inaccurate to say that no unlisted securities enjoy a broad, active market. There are, in fact, listed bonds whose chief market is not the Exchange but "over the counter," that is, by telephone from broker to broker. The outside buyer is entirely at the mercy of the dealer, because there are few published quotations to guide his judgment. There is nothing open about such dealings even if the buyer knows to what dealer to go. The Exchange furnishes a market for any one who wishes to buy or sell securities and he can feel confident that there is always some one who will purchase or sell at some price. For this reason as well as for the advertising

advantage which they receive by having the names of their securities appear in the daily newspaper and on the ticker most corporations of any considerable size are listed upon one or more exchanges.

The Exchange gives securities a definite current price, making it easier for the owner to borrow upon them. Securities that are not listed are not generally available as collateral for loans. The banks use Stock Exchange quotations as the basis for computing the amount they will lend upon given securities.

The many requirements for listing, rules and regulations governing trading, definite uniform rates of commission charges (which are usually lower than those for unlisted securities), and the requirement of an annual report, are further advantages in favor of the listing of securities and to that extent give protection to the investor.

14. *London Stock Exchange listing.*—The listings on the London Stock Exchange are much more international in character than those of the New York Stock Exchange. To give some idea of the relative number of securities on the London Exchange compared with that of New York, it is only necessary to state that a complete list of securities dealt in on the London Exchange is published daily in small type and fills sixteen full pages as large as an ordinary newspaper. London business is extended practically to all corners of the globe, whereas the New York Exchange is confined mostly to home corporations; only a few foreign securities are dealt in, and those spar-

ingly. This is primarily due to the fact that British investors have international interests, and to a minor extent because London's listing requirements are less strict than those of the New York Stock Exchange. The existence of the different incorporation laws in forty-eight states, some of the laws being very lax, makes it necessary for the American stock exchanges to be especially careful what they admit. In Great Britain, there is one uniform law which makes it more difficult to float worthless securities than in the United States. Besides, London does not have a preparatory market like the New York curb market where new securities are traded in before being listed on the exchange, and which gives them a chance to become seasoned.

The New York Committee on Stock-List requires that a corporation show at least one year's earnings before being eligible to list its securities. The London Exchange committee looks into the *bona fides,* makes inquiries concerning the individuals behind the concern but does not require that a concern shall have done business one year and show a year's earnings. In London the theory seems to be that everything should be admitted to the stock exchange for trading.

REVIEW

What is the primary difference between a stock and a bond? How are they quoted in the daily papers?

What is a listed security and wherein does it differ from a non-listed security?

What does the Exchange require of a corporation before its stock can be listed?

To what extent do listed securities protect the investor?

CHAPTER V

EXECUTION OF ORDERS, TRANSFERS AND SETTLEMENTS

1. *Rules and customs regulating transactions.*—When one wishes to buy or sell securities listed on a stock exchange it is not necessary for him to look for a seller or a purchaser as he would need do if he were buying or selling some other form of personal property. He can acquire or dispose of a security thru the medium of a third party, that is, a broker who is a member of a stock exchange where such security is traded in. These dealings thru a broker are made subject to the rules and regulations which these brokers have drawn up for themselves and have agreed to live up to. So when trading in listed securities, contracts for buying and selling are made in accordance with the rules and regulations of the Exchange. These rules are supplemented by customs which have been established among the members and which have come to have the same importance as if they were adopted rules. In general, rules and customs of all American exchanges are similar. We shall not attempt to enumerate here all the various provisions for trading on the exchange as we have already in previous chapters discussed some of them and shall continue to do so thruout the Text.

2. *Bids and offers.*—According to the rules of the Exchange, buying and selling, that is, bids and offers, may be conducted in four ways. These bids and offers are similar except in the time allowances for making delivery of the securities. The transactions are as follows: (1) "Cash," which is delivery of the securities by the seller to the buyer and payment upon the same day they are sold. If the sale is made on a half-holiday observed by the Exchange, delivery must be made at or before 11:30 A.M. A certified check is generally used for making payment, and not cash in the strict sense of the word. (2) In "Regular" or "Regular Way" transactions, delivery and payment are made the day following before 2:15 P.M. If the sale is made on a Friday or Saturday, delivery and payment are made on Monday. (3) A "three days" delivery is made on the third day after the date of contract. (4) "Buyer's or seller's" options are for a period not less than four days and not more than sixty days. These options give the buyer the right to demand delivery or the seller the right to deliver any time during the time of the option. This form of transaction corresponds somewhat to that of "futures," which is used extensively in produce speculation.

The commonest form of transaction is the "regular way." If the seller fails to deliver the security by 2:15 P.M. the following day the proper committee of the Exchange is immediately notified. The committee then proceeds to purchase the securities in

question "under the rule"—that is, on the floor of the exchange, and if a greater price is demanded for them than the original contract price, the difference must be made good by the party who failed to live up to the terms of the contract.

As a stockbroker can buy and sell on the floor of the Exchange only according to ways described, it follows that any person wishing to employ him must be willing to do so in conformity with the rules of the stockbroker's business. It is, therefore, incumbent upon him to have a knowledge of the rules and customs which regulate transactions.

3. *A "regular way" transaction.*—Let us consider further the "regular way" transaction, which is the most usual type of "order" given by a customer to a broker. An "order" to buy or sell may be given to a broker either verbally or in writing, for which there is a regular form. The broker, however, need not consent to act for the customer. A refusal does not necessarily need to be communicated but may be inferred. In case of doubt it is best for the customer to get a clear expression of willingness or refusal. If the order is accepted, the relationship created is that of principal and agent, and the giving of the order may be with or without a deposit of money or securities as the broker may require.

The regular form used is "Buy or sell for my account and risk (number and kind of securities) at (price)." A typical order would be worded: "Buy for my account and risk 100 P. R. R. at 50." Tech-

nical meanings and customs have been applied to these words and it is necessary to describe them before a comprehensive meaning of an order can be understood. The orders of many brokerage concerns are much briefer than the above. Some of the forms simply use the words "buy" or "sell" and all that follows is understood to be included.

4. *The meaning of an order.*—The word "buy" in an order given to a broker who is a member of an exchange means a "contract to buy." The broker does not guarantee the carrying out of the order but he agrees to execute it if possible. He must buy immediately, that is, he must endeavor to contract to buy at once for his customer, from a third party but his failure to carry out the contract does not make him liable. The order is to be executed according to the rules and regulations of the Exchange and according to usages and customs. Buying from a third party must take place in the open market on the floor of the Exchange. The broker is not allowed to offset a buying order of one customer with that of a selling order of the same securities of another customer. Both transactions must be made in the open market. Neither can he sell his own securities to a customer or buy securities from a customer in carrying out such orders. An exception to this rule is made if the broker has the consent of the customer, but even then the transaction must be made at the last market price for the security.

The expression "for my account" means that the

broker is authorized to execute the order for and on behalf of the customer.

The word "risk" in the order is to be interpreted that the customer assumes all risk against failure of having his order executed and that he does not require the broker to guarantee its fulfillment. If the word "risk" is omitted in the order it is nevertheless implied. The customer agrees to pay the broker a commission and all other customary charges for having bought securities for him.

The number of shares in the order is always understood to mean 100, when not definitely stated. If a broker receives an order to buy 100 shares of a given security, he may purchase for his customer a smaller amount if he is unable to buy the entire number. It is quite possible, however, for the customer to so word his order as not to allow the broker to purchase for him less than 100 shares. When the exact description of the security to be bought is not given in the order it is understood to be common where a corporation has both preferred and common stock.

Every security listed on the exchange may be designated by an abbreviation. If the customer in giving an order should use an abbreviation which stands for a security other than what he wished to trade in, the broker has a right to execute the order on the basis of what the abbreviation means in the market, irrespective of the customer's intentions.

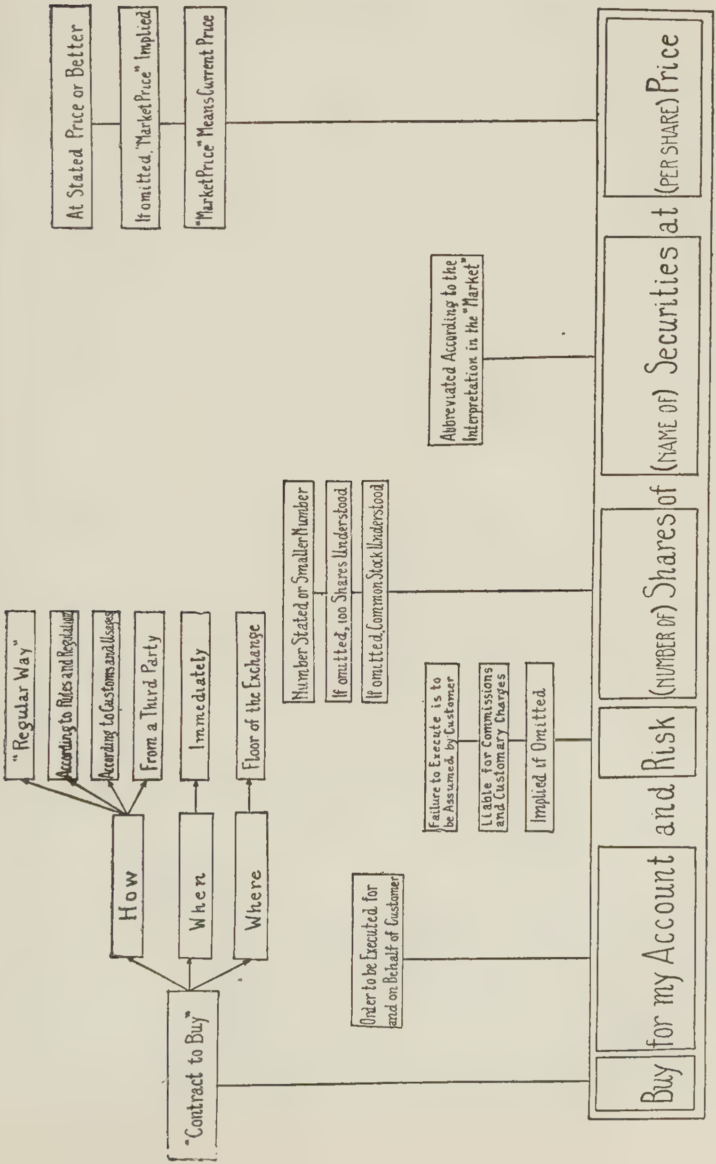
When an order states a definite price it is always understood that the broker must either purchase the

security for his customer at that price or better if possible. That is to say, in the foregoing order he must purchase Pennsylvania Railroad at 49¾ a share, if possible. When the order is a selling order he must sell at a higher price than designated if possible. In other words, he must always act to the customer's advantage.

When no price is given in the order it is understood that the broker will execute the order "at the market price" or "at the market" which means he must secure the best price obtainable at the time of executing the order. The same is true if the price indicated in the order was the "market price." On page 91 is shown a diagram giving the technical meaning of an order.

We have supposed that the order we are using as an example is a "regular way" transaction, and all orders are so considered unless there is a definite understanding to the contrary. All transactions are subject to the rules and regulations of the exchange and the usages and customs of the business.

When an order is accepted by a broker he must execute it immediately. The broker will phone the order to the floor member of the firm. When the floor member has filled the order the rules of the exchange require him to notify his office. They will in turn notify the customer of the execution of the order, stating the price at which the order was executed. This price as given the customer is the gross price, including commissions and other charges. The broker, upon making delivery of the securities, has the



THE TECHNICAL MEANING OF AN ORDER

right to require the payment of the purchase money.

5. *Transfer of securities.*—A customer may have the broker transfer the securities to his name. It will be noticed that stock certificates are not negotiable instruments and in order to pass title from one party to another it is necessary to have the title pass by transfer on the books of the particular corporation. We have already seen that the rules of the New York Stock Exchange regulate to a large extent the transfer and registry of securities. It will be well for the reader at this point to refer to the preceding chapter concerning the Transfer and Registry requirements of the New York Exchange.

Stock certificates have been designated by the courts as non-negotiable instruments because they lack some of the necessary elements that contribute to legal negotiability. On the other hand bonds are usually negotiable. The disadvantages which arise, due to the fact that stock certificates are non-negotiable and that generally corporations do not consider a security transferred unless such transfer is recorded on their books, have been eliminated by the courts by allowing stock certificates to pass freely from one party to another by the medium of an assignment and a power of attorney to transfer.

6. *Assignment and power of attorney.*—Every stock certificate has printed on its back a blank form of assignment and power of attorney to transfer which may be filled out by the owner at the time he makes delivery to another person, or he may simply sign it in

blank thus allowing his broker to fill out the blank spaces. It will be noticed that in the following sample of a blank form of assignment and power of attorney there are three parts: First, the assignment; second, an irrevocable power of attorney to transfer; third, a power of substitution given to the attorney.

Blank Form of Assignment and Power of Attorney

For value received......................hereby sell, assign and transfer unto............................ shares of the Capital Stock represented by the within Certificate and do hereby irrevocably constitute and appoint (Name of Broker) . . . Attorney to transfer the said stock on the Books of the within named Company with full power of substitution in the premises.

Dated................19....   ....

In presence of

....

There is a wrong way and a right way of filling out an assignment blank by a customer when sending stock to a broker. The customer should make sure that he fills in the broker's name in the proper space, and all other spaces should be left blank except those for the date, witness and signature. The form above indicates the proper space for the name of the broker. Should the customer fill in the name of the broker in the space following the words "sell, assign and transfer unto" he would be assigning the stock certificate to the broker and it would then be necessary for the broker to have the stock transferred to his own name on the books of the corporation before it would be in a deliverable form. Furthermore, this would involve

delay and an extra Transfer Tax of two cents per $100 par value or fraction thereof, or two cents per share of no par value—provided value does not exceed $100—and a Federal tax of the same amount.

It may be well to mention here that the purchaser of stock is entitled to have it transferred to his name on the books of the company and that the seller pays the transfer tax. As far as the company is concerned, the transfer of a stock certificate is not complete until it is recorded on its books and until such transfer is recorded the company will continue to pay dividends to the former owner whose name is entered on its books as the owner.

7. *Power of substitution.*—We have indicated in the foregoing form the proper space in which the name of the broker should be inserted. When filled out in this way the broker is given the right to act as attorney to transfer for the customer his stock certificate; and furthermore if the broker wishes to substitute his power to act as attorney to someone else he may do so by simply stamping on the back of the certificate the following form which is known as a "Power of Substitution."

POWER OF SUBSTITUTION

I (or we) hereby irrevocably constitute and appoint ....my (or our) substitute to transfer the within named Stock under the foregoing power of Attorney, with like power of Substitution.

DATED.............19.... ....

In presence of

....

8. *Recording the transfer.*—In most states the transferring of stock, by means of the "Blank Form of Assignment and Power of Attorney," and also when using in addition the "Power of Substitution," passes full legal title. In only a few states must the transfer of stock be recorded on the books of the company in order for the purchaser to be absolutely protected. Where such record is required a creditor of the seller making a claim against him, may serve a writ of attachment upon the company while the stock is still in the seller's name, even tho he has received value for it. In any instance, as stated before, the company does not consider the transfer of stock complete until such transfer is recorded on its books.

We have so far seen how the owner of stock should fill out the "Blank Form of Assignment and Power of Attorney" as found on the back of the stock certificate in order to put it in form for delivery to another person. When sending a stock certificate to a broker the owner may fill in the blank spaces as shown or he may simply sign his name and have it witnessed, permitting the broker to fill in the other blank spaces. All that a person really need do when selling his stock thru a broker is to sign his name on the back of the certificate, have it witnessed and fill in the date. The broker will fill in the other blank spaces and send the certificate to the company's transfer office or agent, where a certificate with the new owner's name on the front is issued and the old one canceled. When mailing a

stock certificate to the broker, it is better as a safeguard to insert the broker's name.

The customer must take care, however, when endorsing the certificate that he does so in conformity with his name as it appears on the face of his certificate. If "Henry Hudson Brown" appears as the owner of the stock on the face of the certificate it must be signed "Henry Hudson Brown" on the reverse side, and not Henry H. Brown.

9. *A detached power of attorney.*—In some instances a detached power of attorney is used instead of the form on the back of the stock certificate. This is done in cases where the stock is used for borrowing purposes or where it is to be sold in the future. The owner of the stock, however, reserves the right to cancel the detached power of attorney provided he desires not to dispose of the stock.

10. *Clearance system.*—When a broker buys securities for a customer or for himself he does not pay cash for them on the floor of the Exchange, neither does he receive the securities at the time the transaction is made. It would be as impossible for a broker to pay cash in return for stock certificates at the time of purchase as it would for a business man to pay cash for all his purchases and accept immediate delivery of everything he buys. Sales and purchases on the exchange are made in the same way that most business sales and purchases are carried on, that is, temporarily on credit. When Broker A buys stock of Broker B each makes a memorandum of the trans-

action and telephones the particulars to his office. As far as the delivery and payment of stock are concerned, except for odd lots and inactive stocks, all details of settlement are handled by the Stock Clearing Corporation which is controlled by the New York Stock Exchange. It might be mentioned that bonds are not included in the operations of the Clearing Corporation, with the exception of Liberty Bonds. All modern stock exchanges have some sort of a system for directing stock deliveries and payments, but among them all there is no system in the world which has the rapidity, flexibility and safety of that established by the New York Stock Exchange.

Before such an efficient system was established stock deliveries and payments between Exchange brokers were made directly. For several years before 1892, when the Exchange instituted its Clearing House, there had been felt the need for some central institution which could eliminate needless duplication in settling the transactions which took place on the floor of the Exchange. Clearing houses already existed elsewhere in this country. The first stock clearing house was created in Frankfort, Germany, in 1867, and London, Hamburg, Berlin and Vienna were not long in establishing similar facilities. The Philadelphia Stock Exchange and the Boston Exchange were the first to establish stock clearing houses in this country.

The system abroad is based on fortnightly settlements while the New York system, with characteristic

American speed, is based on daily settlements made at the close of each day. The New York system has been so very carefully developed that today there is no other which has reached the same height of efficiency. The present system of clearing is conducted by a Stock Clearing Corporation which has recently begun operations. This corporation is capitalized at $500,000, and consists of a Night Clearing Branch and a Day Clearing Branch.

11. *The clearance principle.*—The basic principle upon which stocks are cleared in the Night Clearing Branch of the Stock Clearing Corporation, is very simple. For example, let us suppose that A owes B $100, and that B owes C the same amount, all parties would be satisfied if A paid C $100. If all obligations could be cancelled and settlement made in this way business procedure would be greatly speeded up. But the question arises how is A to know that B owes C $100? If we suppose X were in the position to know what individuals owe money and whom they owe he could direct A to pay the $100 to C instead of B and inform B of the transaction. X would stand exactly in the same relation to A, B and C as a bank clearing house stands to its member banks or a stock exchange clearing house does to its members. Up to this point the clearance principle is easy to grasp, but in addition to clearing money differences, stocks are also cleared. It is because of this fact that many find it difficult to understand the operation of the system. Suppose A sells

100 shares of United States Steel to B for $102 a share and B sells 100 shares of the same stock to C for $103 a share. A knows nothing of B's transaction with C. The Clearing Corporation, however, directs A to deliver 100 shares to C, which he does. B is, therefore, saved the trouble of receiving and delivering the stock. Otherwise he would receive 100 shares from A and deliver 100 shares to C. Thus far the shares only are cleared, but let us see wherein the Clearing Corporation adjusts money differences. Notice that B sold U. S. Steel for $1 a share more than he bought it for, netting him a profit of $100. A sold the lot for $10,200 and C bought an equal lot of U. S. Steel for $10,300. At the time A makes delivery to C he receives C's check for $10,300 or $100 more than he is entitled to. To make settlement of the cash transaction B simply draws a draft for $100 on the clearing house and obtains his profit and A gives his check to the Clearing Corporation for $100, the amount he received in excess of what was due to him. The Corporation will pay B's draft with the proceeds of A's check and the entire transaction is completed.

In actual practice this transaction is not absolutely correct because in reality the delivery of stock is not based on the actual selling price but on an arbitrary delivery price which is determined by the Clearing Corporation for the purpose of simplifying still further its operations. The delivery prices of all stocks appear on the stock market ticker shortly

after the closing of the Exchange each day and are determined by selecting the nearest even quotation (excluding fractions) approximating the last bid or offer of the day on each security. The differences which occur between the actual selling prices and the delivery prices are accounted for in the brokers' checks or drafts when they make settlement to the Stock Clearing House. The Stock Exchange Clearing House simply directs the brokers to whom they are to deliver the stocks they have sold and at the same time furnishes a means of making settlement of the cash differences by checks or drafts.

12. *Clearance illustrated.*—To illustrate the actual working of this clearance system let us suppose that A is the floor broker of A and Company. During the day A will inform his firm by telephone of the purchases and sales that he makes. A and Company will make out on white slips printed in red a delivery (or seller's) ticket for every sales transaction which A made on the floor of the exchange. These tickets are sent by the firm's messenger (or runner) to the distributing department of the Stock Clearing Corporation where they are sorted and the messenger in turn receives from the Clearing Corporation corresponding tickets from the firms with whom A and Company have done business. These tickets verify the transactions made. All tickets that are to be cleared in this way must be forwarded to the Clearing Corporation before 4:30 P. M. otherwise the firm will have to send their messenger to the respective brokers' offices.

All members of the Exchange are not necessarily members of the Stock Clearing Corporation but they are all eligible. Those who are not members of the Clearing Corporation make comparisons of their transactions by this latter direct method.

13. *Clearance sheet.*—After 3 P. M., when the market closes, A and Company will make out what is known as a clearance sheet which shows in detail their purchases and sales for the day, the number of shares of each security they bought and sold, the price, and the brokerage firm with whom the transaction was made. The clearance sheet must be delivered at the Stock Clearing Corporation before 7 P. M. except on Saturday when the time is 4 P. M. The following example of a clearance sheet will show the principle of clearing thru the Corporation.

A AND COMPANY

Received From					*To Deliver*				
B	500	U. S. S.	101	50,500	C	600	U. S. S.	102	61,200
Balance to Deliver	100	U. S. S.	100	10,000					
Balance	(Draft)			700					
				61,200					61,200

The clearance sheet shows the total value of the stock bought to be $50,500 and of the stock sold $61,200. If it were not for the existence of a Stock Clearance Corporation, A and Company would either have to have $50,500 in cash or obtain credit to that extent in order to make settlement by the following day. Furthermore, C would have to have $61,200

to pay A in this particular case. It is seen that these large amounts would simply make settlement for 1100 shares. It is not hard to imagine the tremendous amount of credit which would be required by brokers on days when a million or more shares are traded in.

The clearance sheet shows also that A and Company bought 500 shares of U. S. Steel and sold 600 shares. Without the Stock Clearing Corporation it would be necessary for them to receive and deliver these shares respectively. This organization makes possible the cancelation of the 500 shares bought with the 500 shares sold, leaving only 100 shares to be delivered. As is very frequently the case the buying and selling prices of these transactions are different and the delivery price of the 100 shares that do not cancel is also different from the selling price. All the broker needs to do is to draw a draft against the Corporation for $700 and send it to the Stock Clearance Corporation accompanied by his clearance sheet. If in our illustration the balance had been on the other side A and Company would accompany the clearance sheet with a check.

It is natural that at this point the question should arise regarding the effect of the arbitrary delivery price upon the broker's account. What is to guard the broker against receiving or paying out too much money in making settlement? A and Company having bought 500 shares and sold 600 shares will have to deliver the next day 100 shares, for which they will

receive $10,000 based on the arbitrary price of $100. But they sold that 100 shares at 102 and should receive $10,200. This difference between what they should receive and what they do receive does not represent an arbitrary loss of $200. The firm also bought 500 shares at 101 and sold 500 at 102 (besides the 100 shares just mentioned) and has a gain of $500. The draft for $700 which A and Company draws against the Corporation and which it will pay, adjusts A and Company's account. This delivery price could have been any amount and the results would be the same.

Let us suppose, for further illustration, to prove this point, that the delivery price is 115. In this instance A and Company would deliver the following day only 100 shares of U. S. Steel and receive $11,500, which is $1,300 more than the actual selling price of 102, or $10,200. This would arbitrarily give them a

A AND COMPANY

Received From					*To Deliver*				
B	500	U. S. S.	101	50,500	C	600	U. S. S.	102	61,200
Balance to Deliver					Balance	check			
	100	U. S. S.	115	11,500					800
				62,000					62,000

profit of $1,300. We saw before that they were entitled to $500 profit on the 500 shares that are cleared, having bought at 101 and sold at 102. Instead of it being necessary to give a check to the Corporation for $1,300 and later receive from them the actual $500 gain, A and Company may keep $500 of this $1,300

arbitrary profit due to the arbitrary delivery price and accompany their clearance sheet with a check for simply $800. In other words, this $800 represents first, the difference between the purchase and selling price of the shares that can be cleared and secondly, the difference between the selling price and the arbitrary delivery price for the shares that could not be cleared and which were actually delivered by A and Company and payment received at the arbitrary delivery price. It is evident, therefore, that thru the operation of this arbitrary delivery price A and Company neither lost nor gained, and that it is immaterial what delivery price is used because any losses or gains which arise, due to the fact that the delivery price is higher or lower than the actual contract prices, will be adjusted in the check or draft (whichever the case may be) that accompanies the clearance sheet.

The brokerage houses send their clearance sheets, drafts and checks to the Corporation, where they are examined by clerks to detect any errors. Those which contain mistakes are sent to another set of clerks, who specialize in correcting such errors.

14. *Allotment sheet.*—The Stock Clearance Corporation prepares an allotment sheet for each of the stocks cleared. Since every transaction on the Exchange must consist of a purchase and a sale, the number of shares purchased is equal to the number sold. The purchasers are entered on one side of the allotment sheet and the sales on the other and each firm showing a larger amount of stock sold than bought

will be assigned to deliver to one of the firms which has bought more of that stock than it sold.

If, in the case of U. S. Steel, the only transactions for a particular day were those we have mentioned by A and Company with B and C, the allotment sheet would be as follows:

U. S. STEEL

No.	*Shares*	*Will Receive*	*No.*	*Shares*	*Will Deliver*
1	600	C	1	100	A and Company
2			2	500	B
3			3		
etc.			etc.		

In reality, however, U. S. Steel being an active stock it is more likely to happen that there would be a hundred or more balances to deliver.

A statement of the stock to deliver is next made out by the Corporation for each brokerage house with a stock balance, designating the name of the house to whom it shall deliver stock. This statement is delivered to brokers at half past nine the next morning and A and Company receiving their notice to deliver one hundred shares of U. S. Steel to, let us say, Henry Smith and Company, would promptly send it to them by messenger. If A and Company should fail to deliver or receive stock after passing thru the Corporation they would be dealt with by the Exchange authorities on the charge of failure to fulfill a contract. When A and Company's messenger returns he will bring with him Henry Smith and Company's check for $10,000 (or $11,500 as shown in our second illustration).

The checks received by the Clearing Corporation always exactly equal the drafts drawn against it. The checks sent to the Corporation are deposited in the bank promptly the next morning. The drafts against the Clearing House are signed by the manager under the word "approved" and returned to their makers by 12 o'clock noon of the day following their receipt. This completes the work of the Clearing House for one day's clearance and on that evening they are again ready to begin another day's clearance.

15. *The Day Clearing Branch.*—Up to this point we have explained the operations of clearing as they were formerly carried out by the Stock Exchange Clearing House. This system is carried out at present by the Night Clearing Branch of the Stock Exchange Corporation. The operations of the Day Clearing Branch consist of the clearing of security balances and loans, together with the clearing of special transactions approved by the Stock Clearing Corporation. The clearing of securities is a much simpler process than formerly. The check which a broker would receive upon making a delivery of stock is now credited to his account and goes to reduce his debt caused by stock which he received. In this way a broker needs only to provide for the payment of differences.

Formerly when a broker paid off a loan on which he wished to re-borrow, it was necessary for him to secure first an immediate credit from his bank before

the new loan became effective. Now under the operation of the Day Clearing Branch, banks and other lenders of credit send the collateral on loans to be paid off to the Stock Exchange Clearing Corporation, and while the securities are there, the old loans are paid off and the new loans made at the same time while changes in collateral are being effected.

This function of Clearing has been in operation since April, 1921.

16. *London settlement.*—Settlements of London Stock Exchange transactions are effected only twice a month. London did, for a while during the War, abandon the periodical settlement and required daily settlements as in New York. Shortly after the War, however, it returned to the periodical settlement. It was found that a daily settlement in London resulted in unnecessary hardship because of the larger number of clearings due to the volume of international trade.

At the time the new Stock Clearing Corporation was proposed the question of the advisability of changing over to a fortnightly system was considered. It was asserted that a periodical settlement would not work in the New York market without alterations in the conduct of the money market. It is supposed that one of the reasons the Stock Exchange authorities hesitated to attempt periodic market settlements was because the banks were still heavily engaged in government transactions, facing the necessity of purchasing hundreds of millions of temporary securities issued

by the government for the purpose of liquidating the war debt.

Furthermore, there have been days when the effect of tremendous speculations and at the same time large government transactions incident to income tax and Victory Bond payments have caused such a scarcity of funds for even a one-day settlement that call money rose to 20 per cent and over. It appears as tho the question of periodical settlement is likely to be postponed until the worth of the Stock Clearing Corporation is well established and business activities have lost the effect of the Great War and resumed a more normal basis.

REVIEW

What are the types of transactions made on the exchange? How do they differ?

Explain the full meaning of an order to buy as given to a broker.

How would you fill in the form on the back of a stock certificate when selling thru your broker?

What do you understand by the Power of Substitution?

Broker "A" on October 6 buys 300 shares of General Electric at 142½ from Broker "B" and 200 shares of Union Pacific at 123¾ from Broker "C." The same day he sells 200 shares General Electric at 145½ to Broker "D" and 300 shares of Union Pacific at 124 to Broker "E." Give an explanation of the various steps to which Broker "A" must resort in order to settle these transactions thru the New York Stock Exchange Clearing House. Prove that the check or draft (as the case may be) is the exact amount due to or from the Clearing House.

CHAPTER VI

METHODS OF TRADING

1. *Classes of security buyers.*—For convenience, security buyers are usually divided into two classes. There are, first, those who pay the full purchase price of a security in cash or its equivalent. This is generally designated as buying outright, just as in buying a $10.00 pair of shoes the purchaser hands the salesman a ten dollar bill or a day or two later sends him a check. If every purchaser of securities paid for them in full with his own money, the complications which otherwise arise and which are so much Greek to the average buyer would practically be reduced to a minimum. But such is not the case.

There is another class of individuals, far more numerous than the one just mentioned, which buys securities mostly with borrowed money. They furnish only a part of the funds necessary to pay for the stock, depending on the broker to furnish the balance. It is because of the buying and selling of this class, consisting of "outsiders" as well as "insiders," operating on borrowed money, that there has developed an intricate mechanism, and many technical terms have arisen which are hard for the uninitiated to grasp. This method of buying is known as a "margin" transaction.

The broker in carrying out the orders of both these classes of buyers actually buys the securities and pays for them in full. He does so either with his own funds or he will borrow the money to do so, usually from a bank. The person who pays for stock in full is generally looked upon as a conservative investor while the person who buys on a margin is generally considered a speculator. Speaking broadly this is all well and good since it is true that an outright purchase is safer and more conservative than one made on a margin. There is not, however, any hard and fast line between these two types of dealing.

2. *Variations in cash and marginal purchases.*—There is no difficulty in seeing the difference between the person who regularly trades on a ten per cent margin and the investor who buys outright and never borrows a dollar; but there are innumerable variations between these two types of transactions. There is the man, well known to his broker, who desires to buy a stock today but who has not sufficient means to pay for it, altho tomorrow he will have a note of many thousand dollars coming due and will then complete the purchase. A man of large wealth, also well known to his broker, may wish to buy a stock at once but may not have even a check book with him. Another man buys on a margin and the next day he decides to complete the purchase in full. Again, a man may buy, for example, 100 shares of stock on a ten per cent margin and after a few days

instruct his broker, as he has a perfect right to do, to reduce the account to 10 shares, in which case he is no longer a marginal trader but the outright owner of 10 shares, provided, of course, there has been no decline in price and he has paid all the expenses.

Finally, there is the man who buys outright and the next month goes to his bank and borrows 80 per cent of the value of the stock. He is no longer an outright owner but a margin operator. These illustrations show the danger of generalization about margin trading and indicate also the dangers attendant upon the passage of legislation on the subject. A law might be passed forbidding margins of less than 20 per cent but in an active market a man might have a 25 per cent margin one moment and regard himself as both within the law and safe while at the next moment his margin might be 19 per cent and he would be a criminal even before he could write out a check. In other words it is dangerous to legislate or generalize on the question of how much credit a broker may extend to a customer.

There is nothing inherently wrong about a marginal operation. It is a question of one's resources and ability to meet inevitable debts. It is no more wrong in itself to contract a margin operation in stocks than to purchase real estate on a mortgage or to contract any other debt. It is solely a personal question, to be decided on its individual merits. Unfortunately thousands of persons do operate on margins who have not

sufficient resources; consequently much loss and suffering result.

3. *"Bulls" and "bears."*—Speculators or brokers' customers are often classified as "bulls" and "bears," according to their attitude toward the future movement of the prices of securities. The bulls are those who buy because they expect prices to go higher and the bears are those who sell in anticipation of falling prices. The market is therefore called "bullish" or "bearish" as one or the other class predominates in trading at any one time.

Buyers are said to be "long" of stocks or "long" of the market. Those who have stocks of their own to sell are simply sellers. Those who sell stocks which they do not own, are "short" sellers, or are "short" of stocks or "short" of the market.

A buyer of stock who anticipates a rise in its value may purchase shares in one of two ways. The first is to buy the securities outright, paying the full purchase price for them. Such purchasers take their securities to a vault, lock them up and go on attending to their everyday affairs until such time as their expectations have been realized, when they take the securities to the broker's office, have them sold and pocket the profit they have waited for. If their judgment has been erroneous and the value of securities declines instead of advances, they can either hold the securities until the price rebounds, which very frequently happens, or they can have them sold and suffer the loss. These persons, as a rule, are little concerned

with the banking or brokerage interests. Their stocks having been paid for outright, they require no money to carry them in a falling market. This class, however, is in the minority and as stated before are either investors or conservative speculators. The great majority of those who purchase in anticipation of a rise in the prices of stocks, do so upon a margin by which they advance a small part of the price, the greater portion of the funds being secured by the broker.

4. *Partial payment method.*—A variation of the margin system is found in the partial payment method of buying stocks. Legally and technically it is the same but it varies in certain details. Besides the original margin, which is usually at least $20 a share, the customer agrees to pay about $5 a month until the stock is fully paid for. If the method is followed properly, only high grade, non-fluctuating stocks are purchased. This plan is very safe because the large initial payment is added to regularly on the first of each month, thus constantly bulwarking the stock from being wiped out by a decline in the market.

By the partial payment method a person with $100 is able to buy five shares of a standard stock and pay for it by saving only $20 a month. He will become the owner of five shares of stock costing $100 a share in a year and eight months. The investor can always increase his payments, and if he discontinues them his status is the same as that of the regular margin buyer.

In any margin operation the broker invariably re-

serves the right to call for additional margin at any time, and the customer, on his part, has always the right to demand delivery of the stock whenever he is prepared to pay for it. In the vast majority of marginal operations customers never see the stock because they never pay for it. Margins, it should be noted, may consist of securities as well as cash. "Paper profits," the name for an advance in price which has not been cashed in, may also serve as margin.

5. *"Selling short."*—Those on the other side of the market—the persons who are counting upon a fall in the value of stock—can operate only in one way. Obviously no one could make a profit by buying stock outright, paying for it and then locking it up in anticipation of a fall in its value. It is possible, however, for a man to make money if he can foresee a price decline and govern his transactions accordingly.

It is believed in Wall Street that the public is made up for the most part of bulls, or those who play for a rise in the value of stocks, while the professional traders are more frequently the bears, or those who anticipate a fall in the value of securities. This belief is founded upon the fact that the public, as a rule, does not speculate upon a falling market. Indeed not many understand how the transaction is carried thru. The operation of speculating on a falling market is known as selling "short," sometimes called "selling securities, seller's short." This practice is carried

on extensively. The actual operation of a short sale is described in the next chapter.

6. *"Puts," "calls" and "straddles."*—Still other forms of contracts which may be used by those operating in the stock market are "puts," "calls" and "straddles." These are collectively known as privileges. Sometimes they are called "options" because the buyer has the option of carrying out the contract as he may see fit. These options should not, however, be confused with "buyer's and seller's options" which are quite different. Buyer's and seller's options are used in trading on the Stock Exchange, whereas "puts," "calls" and "straddles" are forbidden in the New York Stock Exchange.

These options furthermore should not be confused with the word "options" as used on the produce exchanges, which mean the months or futures traded in. Such future contracts *must* be carried out—delivery must be made thereon—whereas in the case of a privilege the purchaser may or may not exercise his option. It depends on circumstances whether the buyer of the privilege will require the seller to live up to the terms of the contract. In principle these privileges correspond to an option on real estate, where an operator pays a few dollars down for the privilege of buying a lot two months later at a definite price.

7. *"Puts."*—A "put" may be defined as a contract the terms of which give the buyer of the "put" in consideration of a premium paid, the privilege to *put* to the seller of the contract, that is make the seller of

the contract take from him, a certain amount of securities or produce at a price named, on or before a specified date. The purchaser of a "put" may or may not exercise his right according to whether it is to his advantage or not. The following is an example of the way a "put" is usually worded:

New York..................19

For value received the bearer may Put (deliver or sell) to me on one day's notice except the last day when notice is not required;........shares of the..............stock of the.....................company at..........dollars per share any time in.......... days from date.

All dividends for which transfer books close during said time go with the stock.

Expires at........M.......19 ....

Signature of maker.

8. *"Calls."*—A "call" is exactly the reverse of a "put." It gives to the buyer, in consideration of a premium paid, the privilege to *call* from the seller of the contract, that is, to make the seller of the contract deliver to him a certain amount of securities or produce at a price named on or before a specified date. The purchaser of a "call" exercises his privilege only when it is to his advantage to do so. A "call" is worded similarly to a "put" except the words "call (receive or buy) from me" are inserted instead of the words "Put (deliver or sell) to me."

9. *"Straddles."*—A "straddle" is a combination of a "put" and a "call." It gives the buyer the privilege of putting or calling the securities or produce at the

price named within a given period. It is not necessary for him to exercise this combination privilege, but he may if he wishes exercise only a part of it, either the "put" or the "call" feature. A "spread" is similar to a "straddle," differing only in that the put and call prices differ.

These four privileges are used almost entirely in speculative transactions. They are simply bets upon anticipated changes in the price of the security or produce which is traded in. Because of this fact some states and all of the American exchanges have passed rules forbidding them being traded in on the Exchanges. Altho trading in options is not recognized by the New York Stock Exchange its members may still deal in them and some of them issue circulars showing not only the speculative but the insurance feature connected with these various forms of privileges.

10. *Use of "puts."*—Let us suppose that steel is selling at 100 and A believes it will decline below 97, the price of the "put." He does not wish to sell stock short but instead he buys a "put" for 100 shares at 97 (three points below the market price) paying for it $125, good for thirty days. If it declines to, let us say 90 within the stated time he can then buy 100 shares of U. S. Steel thru the broker at 90 and "put" (deliver or sell) them to the seller of the "put" at 97, making a profit of $700 less $125 (cost of the privilege) and the broker's commission. This illustration shows the use of a "put" for speculative purposes.

As a matter of fact settlement may be made by the payment to A of the difference in price.

To illustrate how a "put" may be used for the purpose of protection, let us suppose U. S. Steel is selling at 100 and A decides to buy thru his broker 100 shares, as he believes it will rise in price. The stock, let us say, rises to 108 and A believes it will go still higher in price but, fearing that his judgment may be wrong, he decides to insure himself against loss and protect part of his paper profit by buying a "put" on 100 shares of U. S. Steel at 105 (three points below the market). U. S. Steel later declines to ninety within thirty days. If A sold his 100 shares that he bought at 100 at the new market price they would net him a loss of $1,000. In order to close out his 100 shares, having bought a "put" at 105 he simply puts to the seller of the "put" his stock for 105 instead of selling it, thru his broker at the market price of 90. By the use of a "put" A has made a net profit of $375, the difference between the purchase price of 100 and 105 the "put" price, less $125, the cost of the privilege. Without a "put" A would have been compelled to sell out his stock at 90 and would have lost $1,000 instead of having a gain of $375.

11. *Use of "calls."*—Let us suppose U. S. Steel is selling at 100 and A believes that it will advance above 103, the price of the "call." He does not care to invest in stock but purchases instead a "call" at 103 which gives him the right of calling for the delivery of

the stock at that price which of course he anticipates will be lower than the prevailing market price at the expiration of his "call." The seller of the privilege has agreed to deliver to A 100 shares of U. S. Steel at 103 any time within thirty days. A calls upon him to do so regardless of the fact that U. S. Steel may advance to a higher price within that time. A calls on the seller of the "call" to deliver to him 100 shares at 103 and then sells them thru his broker at the then prevailing market price and makes a profit, if the stock has gone say to 110, of $700 less the cost of the "call" ($125) and broker's commission.

A "call" is largely used by short sellers or bears who believe the price of the stock will decline and who have sold that which they do not own. Take, for example, U. S. Steel selling at 100. A decides that it is a good stock to go short on and sells 100 shares on the Stock Exchange at that figure. It later declines to 92. He believes it will decline still further but does not dare to trust his judgment. So to insure himself against loss and to protect part of his paper profits which he already has, he buys a "call" at 95 (three points above the then market price) good for thirty days and pays $125 for the privilege. U. S. Steel rises to 110 within thirty days at which point A has a paper loss of $1,000 on his short sale. In order to cover his short sale A calls upon the seller of the "call" to deliver to him 100 shares at 95 instead of buying them at the market price. By the use of the "call"

A has made a net profit of $375, the difference between 100, the short sale price, and 95, the call price, less the $125 paid for the privilege. Without the privilege he would have been compelled to deliver on his short sale at $110 and would have suffered a loss of $1,000.

12. *Use of "straddles" and "spreads."*—The meaning of "straddles" and "spreads" is clear if the "put" and "call" are understood since they are simply double privileges, or combinations. They are used by the individual who believes a big movement in the market is imminent but does not know whether the movement will be up or down. He wants, however, to be aboard when the movement starts, no matter which way it goes. He knows if he can purchase a "straddle" or a "spread" [1] it is immaterial to him which direction the stock moves, just so long as it moves sufficiently in either direction for him to obtain a profit.

Let us suppose again that U. S. Steel is selling at 100. A buys a "spread" on 100 shares good for thirty days "three points each way" for $250. That is to say, A may "put" to the seller of the spread 100 shares at 97 or he may "call" 100 shares at 103, or he may do both at any time within thirty days. If U. S. Steel should go up in price to 110 within thirty days he could sell 100 shares on the Stock Exchange at that price, exercise his "call" at 103 and make a profit of $700 less $250, the cost of the spread. If U. S. Steel should go down to 90 he could buy 100 shares and

[1] The term "spread" is used also in another connection, to describe arbitrage operations in stocks or commodities where there is more than the normal difference in prices between markets.

exercise his "put" at 97 making $700, less $250, the cost of the spread.

A "straddle" differs from a "spread" only in that the "put" and "call" prices are alike. "Straddles" are very little used and can only be purchased when those who sell them expect an inactive market and believe that the price of securities will not fluctuate sufficiently to force them to make good on the privileges which they sell. In the event that the market fails to move beyond the price limits named in the contract the buyer is out of pocket simply the amount which he paid for the privilege.

13. *Prices of privileges.*—The price which must be paid for privileges is based on three factors: (1) the activity of the stock; (2) the number of days the privilege is to run; (3) the number of "points away" the price is from the last sale on the Stock Exchange.

Erie Railroad, for example, is a much less active stock than U. S. Steel. When privileges on Erie are offered ½ point away from the last sale on the Exchange, for thirty days, at $125 for 100 shares, privileges may be offered on U. S. Steel 4 points away from the last sale, for the same premium per 100 shares. The greater the difference in the prices, the less likely is the seller of the privilege to be called upon to fulfill the contract, but he must also take into consideration the conditions of the entire market. When it is wild he is running a greater risk than when it is steady. Also, the greater number of days the privilege has to run the greater the risk of fluctuation.

The use of privileges in the grain market was eliminated by a tax of 10 cents per bushel on "puts" and "calls" levied by the Capper-Tincher Act of 1921.

The only risk, theoretically speaking, which the buyer of a privilege assumes is the amount of the premium he pays for it. It is said that an unskilled speculator loses less money in this than any other way, for he knows exactly what his loss will be, that is, the amount of premium paid. The great difficulty in recent years has been that many irresponsible parties have come to deal in privileges.

14. *Stop orders.*—Another method of preventing loss which is in better repute than the privilege, is the stop order or the stop-loss order, but this method does not give absolute protection against loss. This form of contract is permitted on the Stock Exchange. A stop order given to a broker is simply an order for him to sell or buy at the price named in the order or as near that price as is possible. The reader should distinguish here the difference between a stop order, an order to be executed at a definite price, and an order to be executed at the "market." Stop orders are generally "G. T. C." that is, good till cancelled, but a stipulation may be made limiting the time during which the order holds good.

Let us suppose A buys 100 shares of U. S. Steel at 100. He may wish to limit his loss to say five points in case the price goes down. To do this he may give his broker a stop order as follows: "Sell 100 U. S. Steel Common at 95 stop." As soon as there is a

transaction made on the floor of the exchange at that price the broker endeavors to execute the order at the nearest price to 95 either higher or lower. In the event that the customer has sold short and wishes to limit his loss to five points, he may give his broker an order to "Buy 100 U. S. Steel at 105 stop." As soon as the price reaches 105 the broker will endeavor to buy U. S. Steel at that or the next price at which the stock is offered. That is to say, a stop order becomes a "market order" as soon as U. S. Steel is sold at the price stipulated in the stop order. The broker must act at once when the price of his customer's order is reached because it may so happen that the next bid or offer in an active rising or declining market, may be several points above or below the order price, and slowness on the part of the broker to act may cause considerable disadvantage to the customer. The broker is legally liable in event of his failure to act promptly for his customer but the customer suffers whatever loss there may be if the order is executed properly.

Owing to this fact it will be seen that such stop orders do not absolutely limit a loss as will a "put" or a "call." The statement has been made that more money is lost by "missing the market" thru stop orders than by errors in judgment of market values.

15. *Use of stop orders.*—No general rule regarding the use of stop orders can be stated applicable to all cases. The most successful traders follow the plan of using stop orders to protect their profits. Having

bought stock which has risen in price they place a stop order to protect themselves against losing their entire profit in event of the stock taking a sudden decline in price.

Stop-loss orders may be used advantageously by the banker who has difficulty in securing additional collateral from a borrower when the collateral which he does possess as security for the loan declines in price. He will notify the borrower that he has placed a stop order upon his collateral. When the price goes down to that named in the stop order the collateral will be sold. When a broker desires to protect himself against a customer not keeping a sufficent margin he may inform his customer that he has placed a "stop" at a certain price. The customer may put up additional funds or collateral to protect his margin account with the broker, but if he fails to do so and the stock declines to the price as designated in the stop order the order will be executed.

The expression "many stop orders were uncovered" is often used in describing the daily news of the stock market. This means that the market fell to a point set by holders of stock as a stopping point for their losses and consequently orders to sell were filled by brokers.

16. *Averaging.*—Another common practice for limiting one's losses is averaging. To give a practical illustration of averaging let us suppose A buys 100 shares at 110 and at a later date the price drops to 90. He may then buy another 100 shares at 90 in order

to reduce his loss on his first transaction. This makes his average price for the stock $100 per share. If the stock recovers and goes above 100 he may sell his holdings and realize a profit altho the price may never reach that paid for his original purchase.

17. *Pyramiding.*—Averaging is to "average down" whereas pyramiding is to "average up." It is the reverse of the method just explained, that is to say, buying first moderately and as the price of the stock advances, continuing to buy. It denotes the use of "paper profits," not realized upon, to extend one's operations. This method of speculating requires great care for the market may react to the average price, and go lower, and herein lies the danger. When successful the profits from this method of trading are large.

18. *Scale plan.*—A method of trading which is generally employed by large operators is known as the scale plan. In order to operate successfully under this plan it is assumed that the individual knows approximately the value of the stock in which he proposes to trade. He should consider the tendency of the general market, figure out whether the stock is relatively high or low in price and should be fairly certain of its value for the future. Having considered these things he will lay out a campaign for himself on the theory that he will make his first purchase of that stock at what he has figured to be the right price and the right time. He will then place an order with his broker to purchase for him an equal number of

shares every time the price of the stock drops a point. He will continue to do this as far as the stock may decline. Knowing the value of the stock he feels reasonably secure in what he is doing. His feeling concerning the stock is similar to the merchant who buys staple goods. If the article is cheap at $100 he knows it is cheaper at $95 or $90 and will strain a point to purchase more of it at $80 or at $70, knowing that eventually the price will recover. This is the viewpoint large operators take on their favorite stocks and that is why they generally make money in them.

The small investor is at a disadvantage in following this method because he seldom has sufficient capital. Furthermore, he is not in the position to know the value of the stock in which he trades. He may know the truth up to a certain point but beyond that there may be certain inside information which may materially interfere with the result.

A considerable decline in the price of the stock usually causes the small operator to fear that he has overlooked some factor of importance and he is then tempted to sell his holdings. This scale plan is nothing more than intensive averaging.

19. *"Rights" or subscription privileges.*—The circumstances under which "rights" or subscription privileges are issued has already been explained in the Text on "Corporation Finance." A "right" is a privilege to subscribe to additional stock (sometimes bonds) of a corporation at a price lower than the market price of the stock. This privilege is given to stockholders of

the corporation and it may be sold and transferred, for it has a market value.

20. *Quotation and meaning of "rights."*—It is important at the outset to note the manner in which these "rights" are quoted on the exchanges. The quotation of "rights" in the Philadelphia Stock Exchange is on a different basis from that employed in New York. This is due to the fact that these exchanges give different meanings to the term. In Philadelphia the term "right" means "the privilege to subscribe to one share of the new stock" whereas in New York the term "right" means "the privilege of one old share to participate in the new issue." It is on this basis alone that the prices of "rights" differ on these exchanges.

For example, let us suppose a corporation gives the privilege to its stockholders to subscribe to the extent of 10 per cent of their holdings. If A is the owner of 100 shares he would be allowed to subscribe to 10 new shares. This privilege has a market value and A can, if he so desires, sell his privilege to subscribe either in whole or in part. According to the above definitions of a "right," A would have in Philadelphia, if he were selling his entire privilege, 10 "rights" to sell. That is to say, A would have as many "rights" as the number of new shares for which he may subscribe because a "right" according to its meaning in Philadelphia, is the privilege to subscribe to one new share. On the other hand, if he were selling his "rights" in New York he would have 100 to sell. This is because a "right" in New York means

the privilege of one old share to participate in the new issue and A's holdings being 100 shares he therefore has 100 "rights" which he may sell.

By selling this entire privilege in Philadelphia he would have for sale 10 "rights". In either instance, whether he sells his "rights" in Philadelphia or in New York, he should get approximately the same number of dollars for the entire privilege. According to the illustration, one "right" in Philadelphia would be worth ten times as much as a "right" in New York and it is on this basis that we find "rights" quoted in the two cities.

If the corporation had given its stockholders the privilege to subscribe to 25 per cent of their holdings, then A, owning 100 shares, would have the privilege to subscribe to 25 new shares and the privilege would be equivalent to 25 "rights" in Philadelphia or 100 "rights" in New York, thus making a "right" in Philadelphia worth four times as much as in New York.

The following table will show the number of "rights" and the relative value in Philadelphia and New York on the basis of one hundred shares.

Relative Value of Rights in New York and Philadelphia on the Basis of 100 Shares

Amount of Privilege	Number of Rights in Philadelphia	Number of Rights in New York	Value of a Right in Philadelphia compared with the value of a Right in New York
10%	10	100	10 times
20%	20	100	5 times
25%	25	100	4 times
33⅓%	33⅓	100	3 times
50%	50	100	2 times
100%	100	100	equal

21. *"Rights" and "ex-rights."*—When discussing stock quotations in Chapter IV we noted that the price of a stock reflects a company's dividend, other things being equal, from one dividend-paying period to the next, and also that the price of the stock will drop, on the day it commences to sell ex-dividend, an amount equal to that of the dividend, provided there are no counteracting factors. Similarly, when a corporation intends to issue a privilege to its stockholders to subscribe to additional stock, the price of the stock will reflect the value of its privilege. After a corporation has issued its announcement of the privilege to be given to its stockholders, the stock will sell "rights on" until the date when the books of the company are closed. On this date the stock will then sell "ex-rights" and its price will drop, other things being equal, an amount equivalent to the value of the "right." The purchaser of the stock when it is selling "ex-rights" is not entitled to the privilege to subscribe.

22. *Methods used to dispose of "rights."*—Altho the stockholder of a corporation receiving a privilege to subscribe to additional stock is free to dispose of it, he may, on the contrary, exercise his privilege and purchase that proportion of the new issue to which he is entitled. By so doing he will generally make a very profitable investment. Corporations usually require payment for the new shares in instalments and as a rule will pay the subscriber interest on his partial payments.

If, however, the stockholder wishes to dispose of his privilege to subscribe he may do so by selecting any one of four methods.

(1). He may sell his "rights." This procedure enables the stockholder to realize his profits at once and he is then certain what the amount will be. By choosing any of the other methods he cannot realize his profits until the new stock is issued and therefore he is unable to determine in advance the amount of his profit. On the other hand, the market value of "rights" is usually lower than their full mathematical value because they are generally bought by speculators and arbitrageurs who will pay only a price which will enable them to make a profit.

(2). The stockholder may subscribe to the number of shares to which he is entitled with the purpose of later selling them when they are issued. Such a transaction would take into consideration that a stockholder may need to borrow the money to make his instalment payments on the subscribed stock. For these funds he must pay interest, usually at a rate greater than the interest allowed by the company on the instalments. Besides, it may be a long period from the date of the first instalment to the date when the stock is issued.

(3). The stockholder may sell a number of shares of his holdings equivalent to his privilege and later subscribe and replace his holdings with the new shares. By this method the stockholder gets the full value of his stock and is not required to sacrifice even a

small amount as in the first method where he sells his "rights." It should be noted, however, that in order for the stockholder to be able to subscribe to his entire privilege he cannot sell any of the shares of his original holdings until the stock sells "ex-rights;" otherwise he would lose the right to subscribe. If he sells the shares after the date on which the books of the company have closed he will still retain the right to subscribe.

(4). He may sell short a number of shares to his privilege and later subscribe, using the new shares when issued to cover his short sale. This method would be identical with that of conducting a short sale.

The method which the stockholder should select in order to realize the greatest profit depends upon the circumstances surrounding each particular issue of stock. Therefore, it is impossible to determine in advance which method is the most advantageous.

REVIEW

What is meant by buying on "margin"?

How does the "partial payment" plan differ from ordinary marginal purchasing?

Distinguish between a "put" and a "call" and explain the uses of each.

Explain the operation of a stop order.

What is the difference between averaging and pyramiding?

What are "rights" and how are they quoted?

Explain the various methods by which one may dispose of his "rights."

CHAPTER VII

THE SPECULATIVE TRANSACTION

1. *A margin transaction.*—A margin transaction is a contract between the customer and broker; the customer wishing to buy a certain stock, but not caring to pay the full purchase price, instructs the broker to buy the stock for him on margin. In other words, the customer will pay a part of the purchase price and the broker will supply the balance of the funds necessary, holding the stock as collateral for the amount he has advanced. It is customary for the broker to lend the customer the larger part of the money needed to make the purchase with the understanding that the stock remains in his possession or under his control as protection for his loan and that the customer will pay interest on the amount lent.

Margin trading is carried on in one form or another in nearly all lines of business; in real estate, for example, where only a part of the purchase price is paid and a mortgage is given for the difference; or in merchandising, where the merchant pays only part in cash and the balance at some later date. Margin trading is only one form of extension of credit and resembles loans made by the banks and secured by collateral.

2. *The purpose of margin trading.*—It may be the intention of the purchaser of a stock on margin to pay up, at a later date, the balance he owes the broker and take title to the security, holding it as an investment; or it may be his purpose simply to wait for the market price of the stock to advance to a point where he can sell and make a profit.

It is more or less true that one buying on a margin keeps in closer touch with a company's operations, general conditions and the price changes in the stock market, than in buying outright. He feels that he is in a better position to take his profits when the stock rises in price or to limit his loss by prompt action if it declines. On the other hand, if he buys stock outright and has it locked up in a safe deposit vault, he usually feels secure. He is of the opinion that if the price goes down it will shortly advance to higher levels. In such instances he is more apt to get entirely out of touch with the conditions affecting his stock and thus miss an opportunity of realizing a substantial profit.

It is apparent that buying on margin increases one's buying power. Most speculators, tho in countless cases unwisely, desire to operate with as little of their own money as possible. They realize that their profits are greater by not buying outright. A man, for instance, who would buy 100 shares of a stock at $100 each would have $10,000 invested. If the stock rose to $110 he would make $1,000, or a profit of one-tenth of his capital. If, however, he bought stock on a

margin he could probably buy 100 shares with an advance on his part of $1,000, the broker furnishing the balance. The profit upon the transaction would be the same, but instead of making a profit of one-tenth of his capital, he would make a profit of one hundred per cent of the amount of his original investment. As a rule, speculators prefer, even when they have large financial resources, to buy stock on a margin.

It is true also that by trading on a margin a speculator can diversify his purchases much more widely. He can operate not only on a wider scale, but also on a larger scale. Furthermore, he is better able to mitigate his losses by operating in various directions.

The fact should not be overlooked that one may, when buying on margin, buy a dividend paying stock where the income return is greater than the interest which he must pay on the amount the broker lends to him. For instance, if the stock at the price for which it is bought would net a return of 8 per cent and interest for the unpaid balance is 6 per cent, the trader will make the surplus over and above his interest charges. That is to say, if a person buys on a ten point margin 100 shares of stock selling at $75 a share which pays $6 a share annually in dividends the original investment would be $750. The customer would pay 6 per cent to the broker on $6750, the unpaid balance, or $405 for interest charges, but at the same time the stock would net him $600 in dividends. The difference belongs to the customer and not to the

broker. This illustration will serve also as an example of what is known as arbitraging in interest rates.

If the price of this stock should rise to $85 a share the customer would make $10 on each share, or $1000 plus interest earnings and less commissions on an original investment of $750.

3. *Abuses of margin trading.*—Margin trading also has its unfortunate side. A stock may decline as well as rise in price. The danger is that if the stock declines far enough the speculator may lose his entire initial payment unless his puts up more margin. If he does not do so, the broker will sell the stock for what it will bring in the market and retain that part of the proceeds to cover the loss. If the margin is completely exhausted the customer is "wiped out." The broker is often obliged to sell the customer out in order to protect himself. Margin trading can be abused like any credit account, that is, one can carry more stock than he should. In any margin transaction the broker invariably reserves the right to call for additional margin at any time. On the other hand the customer has always the right to demand the delivery of the stock by paying the difference between the amount advanced by him and the amount paid for the stock by the broker.

4. *The amount of margin required.*—The usual amount of margin required of the customer is ten points or $10 a share; altho during the uncertain markets which accompanied and followed the war,

many brokers insisted that the margins be much larger. The amount varies, depending on several conditions and events. Some brokers require more margin than others. Well-known, wealthy, and highly responsible persons are allowed smaller margins than others. The amount of the security and its nature exerts large influence in determining the necessary margin. Some securities, either because of their high price, speculative character or inactivity, show greater price changes than others having the advantages of an ever-ready market, on this account higher margin is required. Highly speculative stocks are not bought on margin at all by responsible brokers. Very high priced stocks are not safe to buy on margin and low priced stocks, if steady in character, do not require large margins. The general character of the entire market at the time the transaction is made is still another factor which is considered.

5. *Rate of interest charged.*—The rate of interest the broker charges the customer on the difference between the margin advanced by the customer and the amount which the broker paid for the stock varies also. If the customer's account is large and active, the broker may charge a smaller rate of interest than if the customer has a small and more or less inactive account. One of the sources of the broker's income is his "interest accounts." This expression has become technical for the money the broker lends to his customers. The custom is for brokers to charge a trifle more for the money lent than they themselves pay to

the bank for it and, according to the rules of the stock exchange, they are not permitted to charge less. The securities bought by the broker are used as collateral for the loan he makes at the bank in order to supply the necessary funds to purchase the stock for the customer.

Brokers do not have sufficient capital to carry all their loans themselves, so they must necessarily use the stocks which they are carrying for customers on margin as collateral for their loans. The amount the banks lend on stocks varies at different times according to the securities and circumstances. Ordinarily the bank will lend on good collateral up to 80 per cent of the market price, requiring of the broker at least 20 per cent margin. Customers are ordinarily charged six per cent on the amount necessary to make up the purchasing price. It has already been noted that to offset the customer's interest charge he is credited with all dividends on the stock.

6. *When a broker may close a transaction.*—In margin transactions it is always assumed, unless otherwise stipulated, that the broker has the right to close any transaction with his customer at will provided he gives reasonable notice of the time and place of sale. It is not required that he give the customer the reason for his action.

The question as to how much time and notice of sale the broker must give the customer is simply a question of what is reasonable. That depends on the circumstances of each case. Location of the parties, the

physical possibility of the customer's being able to comply with the notice (he may be out of town and cannot be reached), the condition of the market itself, and the nature of the stock must be given consideration. In some cases, the courts have held, one hour to be sufficient notice, whereas in other instances one week has been considered a fair amount of time.

The fact that a customer pays the broker a margin entitles him to part ownership in the securities, altho he does not actually get title to them, and as long as the margin is kept sufficient for the purpose of the broker, the broker is not allowed to sell them without permission from the customer. When a broker wishes to sell out a customer, he does not have to wait until the price declines so low as to make him incur a loss; he may sell the customer's stock before that point is reached.

The reason for this interpretation of the law is that inasmuch as the device of requiring margins was created to protect the broker, no protection is afforded him by forcing him to suspend judgment and action until a loss is incurrred.

If a broker decides that a larger margin is necessary he must notify his customer in exact terms of the amount required to carry his account still further. Reasonable time must be given to the customer to make good the additional margin. The period of time varies. Before the broker ultimately sells, notice of the time and place of sale must be given to the customer, provided the security is held as pledge. When

this is found to be impossible, after making every effort to find his customer, a broker is then free from the obligation actually to serve notice concerning the time of sale, and is also free from the obligation to give the customer reasonable time within which to advance the sum requested as additional margin.

Very often brokers who conduct extensive transactions with the public, print at the foot of their notices of purchases and sales the following sentences, or others to a similar effect:

> It is agreed between broker and customer that (1) all transactions are subject to the rules and customs of the . . . exchange and its clearing house; (2) all securities from time to time carried on the customer's account may be loaned by the broker or may be pledged by him either separately or together with other securities, either for the sum due thereon, or for a greater sum, all without further notice to the customer and (3) in all marginal business the broker may close transactions by the sale or purchase of securities at his discretion when the margin is near exhaustion, without further notice to the customer.

The safest way for a broker to carry on transactions of this kind is to secure in writing from his customer, every time business dealings are carried on, the permission to protect the customer's interests to the best of his ability by exercising his own discretion regarding the securities he buys.

The whole question of margins is succinctly described in a legal decision, that of Markham vs. Jaurdon (41 N. Y. 235):

> The customer employs the broker . . . to buy certain stocks for his account, and to pay for them, and to hold

them subject to his order as to the time of sale. The customer advances 10 per cent of their market value and agrees to keep good such proportionate advance according to the fluctuations of the market. . . . The broker undertakes and agrees (1) at once to buy for the customer the stocks indicated; (2) to advance all the money required for the purpose, beyond the 10 per cent advanced by the customer; (3) to carry or hold such stocks for the benefit of the customer so long as the margin of 10 per cent is kept good or until notice is given by either party that the transaction must be closed. An appreciation in the value of the stocks is the gain of the customer and not of the broker. (4) At all times to have in his name or under his control, ready for delivery, the shares purchased or an equal amount of other shares of the same stock. (5) To deliver such shares to the customer when required by him upon the receipt of the advances and commissions accruing to the broker; or (6) to sell such shares upon the order of the customer, upon payment of the like sums to him, and account to the customer for the proceeds of such sale. Under this contract the customer undertakes (1) to pay a margin of 10 per cent on the current market value of the shares (2) to keep such good margin according to the fluctuations of the market and (3) to take the shares so purchased on his order whenever required by the broker, and to pay the difference between the percentage advanced by him and the amount paid therefor by the broker.

7. *Legal relation of broker and customer.*—From this outline of the duties and relationship of customer and broker it will be observed that there are three steps in the trade which involve different legal rights:

(1) There is the relationship of principal and agent. The broker is ordered by the customer to make purchases of certain securities which he should proceed to do with diligence and care. For his

trouble in performing the duties of agent he receives a stipulated rate of commission. His task once performed, he assumes immediately a different legal rôle.

(2) The broker's functions are then transferred from the territory of agency into the field of credit. His principal, the customer, is now the debtor and the broker becomes the creditor. Inasmuch as the customer merely pays down 10 per cent or thereabout and leaves the remaining sum to be raised in some way or other by the broker, the broker becomes the creditor of the customer.

(3) The final transformation takes place when the securities the broker has purchased are delivered to him. While the customer is the legal owner of the securities, they remain in the possession of the broker because he has a lien on them for all the money he has advanced directly or indirectly and for his unpaid commission charges. Here we have the relation of pledgor and pledgee. The total sale price less the amount advanced by the broker, plus interest on this amount and the commission fees, is turned over to the customer in case of sale.

As a result of so many complicated relationships, disputes frequently arise between brokers and customers. The actual transaction of business, however, proceeds far more smoothly than might be supposed. When one considers the immense volume of business, disputes are relatively few. The average stock operator never suspects the intricate legal, financial and accounting relations that exist between him and his

broker for the simple reason that the machinery takes care of them without a hitch. On the Stock Exchange such disputes as do arise are far more often settled by the committees of the Exchange than by recourse to law.

8. *Rights of customers when broker fails.*—Altho failure among Stock Exchange members is comparatively rare, when it does occur, many legal difficulties arise. The solution of these difficulties depends upon the application of a principle of equity which provides that persons entitled to specific property or money can recover that property or money as long as they can identify it. In a leading case on this principle the English judge who made the decision said: "Supposing the trust money were 1000 sovereigns, and the trustee put them into a bag, and by mistake, or accident, or otherwise dropped a sovereign of his own into the bag, could anybody suppose that a judge in equity would find any difficulty in saying that the *cestui que trust* (the customer) has a right to take 1000 sovereigns out of the bag?"

With this principle in mind, let us examine a few of the circumstances that might arise when a broker fails. Customers who cannot trace their money or securities into a special fund become general creditors and share with the general creditors in the estate of the insolvent after the specific liens or claims have been satisfied. If a customer has given his broker money to buy securities outright, he will be entitled to the securities or to the money if he can identify

the one or prove into which bank account the other has been placed. The same situation arises when a customer sends securities to his broker to be sold. He is entitled to the identical securities if they have not been sold or to a repayment of the proceeds of the sale if he can show into what fund or account they have been deposited.

Where a broker pledges securities *en bloc* part of which were purchased for some customers on margin and the rest of which were purchased outright, the margin customers have inferior equities to the outright purchasers, since the hypothecation of the margin stock was rightful and the hypothecation of the other stock was wrongful. Securities pledged by a broker cannot be released unless the pledgee has paid his debt. That is to say, if a customer owes the broker $1000 on stock, and the broker pledges the stock to a banker for $1200, the banker is entitled to his $1200 before being compelled to give up the stock.

It will be remembered that under the rules of the New York Exchange, members who are creditors of an insolvent fellow member have a first lien on the value of his seat.

9. *Short selling.*—The profits derived from a short sale are obtained by buying low and selling high, which is no different than those obtained from any other kind of a sale. In most sales the seller first buys some commodity and afterwards sells at a higher price, thus obtaining a profit. The difference between this method of trading and short selling is that

the short seller sells before he buys. The ordinary stock trader buys, let us say, a stock at $100 and then waits for it to go up in price. In market terminology he is known as a "bull" as he expects to make a profit out of a rise in the market. When the stock reaches $105 he then sells it and obtains his profit of $5.00 per share. On the other hand the short seller thinks the stock will go down in price. He is called a "bear." He will, in such a case, sell stock at 100 (in spite of the fact that he does not as yet own it) and wait for it to go down to 95. Then he buys it and "covers," that is, completes the transaction, thus obtianing his profit of $5.00 per share.

The business man unacquainted with brokerage transactions is at once struck with the fact that a speculator who sells stock short really sells something he does not own. When stated this way such a transaction, at first glance, seems to be distinctly a questionable course of action, and as a result much popular suspicion is directed against it. If one stops to think for a moment he may recall any number of instances in ordinary commercial business where one sells that which he does not own. For example, when Jones goes to Smith's hardware store and orders a standard article, such as a handsaw, Smith may agree to send it to Jones's house the next day. He takes Jones's money altho at the same time he knows he has no such saw in his store. Smith knows, however, where he can buy such a saw for $2.00. He charges Jones $2.50, and afterward "covers" the transaction by buy-

ing the saw elsewhere for $2.00, delivers it to Jones, and thus makes a profit of 50 cents. The stock speculator who sells short is really doing with the sale of stock what Smith did with the sale of a handsaw.

This same principle is applied when a builder contracts to build a house within a definite time for a specified price. Is he not selling material and labor short? Again, a wholesaler takes orders for finished products at a definite price and promises delivery at some specified future time. He expects in the meantime to get such finished products from the manufacturer. Is he not selling something that he does not possess?

10. *Operation of a short sale.*—In order that the short sale method may be made clearer let us take an illustration. Suppose a man believes that he has inside information that a decision will be rendered by the Supreme Court of the United States which will be very disastrous to the interests of a certain railroad company. He reasons that as soon as the decision is announced it will immediately cause a sudden fall in the value of the stock of this corporation. The market is quick to learn of every favorable or unfavorable condition that may affect the securities which are handled upon the Exchange. Now if the man desires to take advantage of the opportunity which he believes is presented, he will sell short—let us say—300 shares of this company's stock in order to make a profit from the fall in price which he feels

certain will come. The broker, having been directed to make this sale, and having received the funds needed for the transaction, now proceeds in the regular way provided for under the rules of the Exchange. He sells 300 shares of the railway company's stock for the customer, knowing that at that time the customer in all likelihood does not own or intend to purchase the 300 shares of stock which the broker must deliver. Under his contract, the broker must turn over the stock to the buyer before 2:15 P. M. on the day following the sale. Before this time arrives the broker borrows the stock.

11. *Lending stocks.*—There are a number of persons in Wall Street, and some connected with every exchange, who make a business of lending stocks to brokers who desire to put thru short sales. In the New York Exchange there is a post on the floor, around which those who wish to lend stock or to borrow it can gather and effect their transactions. It may upon first thought seem strange that any one should desire to lend stock, yet such a transaction is not without its advantages. The borrower of the stock must deposit with the lender a sum of money equal to the market value of the stock at that time. In other words, he must deposit the equivalent of its purchase price in the open market. This deposit gives to the lender the full value of the stock and at the same time entitles him to demand at any time, upon short notice, that the stock be returned. If he

had decided to borrow money upon the stock as collateral, instead of loaning it, and had taken it to a bank, he could not have secured its full value, but perhaps would have been given only 80 per cent of the full amount. He, therefore, can raise 20 per cent more money upon his security by lending than he can by using it as collateral for loans. It is largely because of this fact that there are usually many lenders of securities in the market.

The broker now has in his possession stock which he has borrowed. He takes this and makes delivery in accordance with the rules of the Exchange. The transaction between the selling and the buying broker seems regular in every way and there is nothing on the face of it to indicate that the sale was at all extraordinary. The fact is, however, that the broker's customer has sold and delivered stock which he did not own, but which he hopes to be able to buy later at a lower price. If the expectations of the customer come true and the court decision, rendered in accordance with his forecast, causes the value of the stock to decline, he will be in a position to profit by the perspicacity that led him to take the risk, for he can go into the open market and purchase 300 shares of the railway stock at a lower price than that at which he sold it. As soon as he receives the securities, which he now buys, his broker takes them to the firm from which the stock was originally borrowed, turns them over and receives a check for the amount of money

originally deposited, together with interest upon the sum at the prevailing rate for the time during which it was in the hands of a lender of the securities.

On the other hand, the customer, may have inaccurately forecasted the nature of the court's decision and the stock may advance upon the strength of the favorable ruling. In this case he would endeavor to cover his "short" sale. He would do this by buying stock in the open market as speedily as possible. He would, of course, have to pay more for it than the amount for which he sold it. The broker would turn the securities over and get back his original deposit, and the customer would lose the difference between the amount that he was forced to pay for the stock, plus costs and charges and the amount for which he sold it.

12. *A short sale briefly stated.*—The course of a short sale can be made graphic by an illustration:

1. A sells stock, which he does not own, to B.
2. A borrows stock from C and delivers it to B, who never learns that it was borrowed stock, and does not care, since he actually has possession of the stock.
3. A goes into the open market and buys an equal amount of the same stock from broker D, and hands it over to C, thus covering and completing the transaction.

13. *Lending rates.*—It must be remembered that when C lends stock to A, he receives as security its full market value at the time, in a certified check

which must be kept "market to market"; that is, if the stock goes up several points, C receives a check for the difference from A, if it goes down, he sends a check for the difference to A. To put it in other words, payments are made either way, as prices fluctuate, in order that the lender of the stock may always have the cash equivalent of the current market value of his stock. But C pays A interest on this cash at a trifle more than the prevailing call-loan rate. He is willing to make this arrangement for reasons already mentioned.

If, however, the stock that C lends is very scarce and hard for "shorts" like A to borrow, C may pay a very low rate of interest indeed—far less than the call-loan rate. He may even pay nothing at all, in which case the stock is said to lend "flat." This happens only when that particular stock is very hard to borrow. Finally, the stock may become so scarce that C, instead of paying interest, may actually receive interest. Then the stock is said to lend at a "premium." In that case C, the fortunate possessor of stock, gets not only the full market value for the temporary use of his stock, but a commission for its use besides. These interest rates and premiums are expressed in percentages such as 1/32 per cent (per day).

14. *Broker and customer.*—When a customer issues an order to his broker to sell short securities on margin, the understanding is that the broker will obtain them and deliver them to the buyer. The inter-

esting question is: where does the broker secure stocks to be delivered? There are four possible sources; (1) other brokers; (2) outsiders; (3) such securities as the broker carries for other customers, if these customers permit him to use them, and (4) whatever securities the broker himself may have.

The customer must pay all interest charges during the period of sale, as well as all premiums that the broker may have to pay in the process of borrowing securities on the market. The lender of stocks—not the short-seller who is borrowing the stocks—gets all the dividends that they pay. The broker cannot terminate his loan of securities to the customer whenever he desires, and if, after he borrows from another member of the Exchange, his loan is called in, he must replace it in some way or other.

In regard to interest on the proceeds of the short sale, no definite, clear-cut custom has been adopted. As a rule, no interest is allowed; but where large transactions are involved, special arrangements are made for the distribution of interest charges between the two parties. In the case of the margin that the customer advances no question arises, since it is taken for granted that interest on it will be paid him.

15. *Market effects of short selling.*—In any normal market there is always a considerable "short" interest; in other words, there are a considerable number of persons who are selling stock short in anticipation of a decline. There is likely to be considerable "long" interest at the same time; that is, it is likely

that there will be a number of persons who have bought stock in anticipation of being able to sell it at a higher price. The conflict between these two interests, together with the influence exerted by those who buy outright, is the force which largely fixes the price of securities. A very active long interest, and the consequent purchase of stock in large amounts, will force prices up. On the other hand, large short sales result in heavy offers and buyers can sometimes be found only when price concessions have been secured. When either one or the other of these interests achieves a dominant influence on the market a reaction in the prices of stocks will usually follow immediately.

The hammering on the prices of securities, caused by constant short selling, drives prices so low that the bulls see a chance to make an advance. Their efforts are frequently aided by the outside buyer, who figures that the existing price of the security offers him a desirable investment. The buying done by these two classes of operators immediately absorbs all the stock that the shorts offer. As soon as this movement begins, in fact, sometimes before the price of the security has been advanced, the short interests "scramble to cover," buying in stock to close up their transactions.

16. *Dangers and advantages of short selling.*—Short selling is dangerous for the seller unless there is plenty of stock available for borrowing purposes. This is because lenders of stock can call in their loans

at any time. Thus the short seller may be faced with ruin unless there is another lender ready. As a matter of fact, loans of stock are constantly being called in, renewed or placed with other lenders.

Short selling is safe only when the stocks that are sold have a large "floating supply," in other words only when a large proportion of the outstanding stock is available for speculation instead of being locked up in the vaults of investors. The only kind of stock which it is really safe to sell short is that which is constantly in the hands of brokers and actually entered in their names on the company's books. For many years United States Steel common was such a stock because most of it was held by brokers in their own names for customers who had bought it on margin. The largest lenders of stock are brokers and the stocks that are most available for lending are those which brokers hold on margin for speculators.

Preferred stocks, choice investment stocks and those that are very high-priced are not suitable for selling short. When shorts cannot borrow stocks at all, a corner exists. Corners are described in detail in Chapter XII.

17. *Justification of short selling.*—In justification of short selling, Professor S. S. Huebner writes in the *Annals of the American Academy of Political and Social Sciences:*

Short sellers do not determine prices. By selling they simply express judgment as to what prices will be in the future. If their judgment is wrong, they will suffer the

penalty of being obliged to go into the market and buy the securities at higher prices. Nine-tenths of the people are by nature "bulls," and the higher prices go, the more optimistic and elated they become. If it were not for a group of "short sellers" who resist an excessive inflation, it would be much easier than it is now to raise prices thru the roof; and then when the inflation became apparent to all, the descent would be abrupt and likely unchecked until the basement was reached. The operations of the "bear," however, make excessive inflation extremely expensive and similarly tend to prevent a violent smash because the "bear," to realize his profits, must become a buyer.

The writer has been told by several members of the New York Exchange that they have seen days of panic when practically the only buyers who were taking the vast volume of securities dumped upon the Exchange, were those who had sold short, and who now turned buyers as the only way of closing their transactions. They were curious to know what would have happened in those panic days when everybody wished to sell and few cared to invest, if the buying power had depended solely upon the real investment of the outside public. . . . Short selling is thus a beneficial factor in steadying prices and obviating extreme fluctuations. Largely thru its action the discounting of serious depressions does not take the form of a sudden shock or convulsion, but, instead, is spread out over a period of time, giving the actual holder of securities ample time to observe the situation and limit his loss before ruin results. In fact, there could be no organized market for securities worthy of the name if there did not exist two sides, the "bull" and the "bear." The constant contest between their judgments is sure to give a much saner and truer level of prices than could otherwise exist.

18. *Arguments against short selling.*—Examining the case in more detail, and restating some of the arguments noted by Professor Huebner, we find that three

valid arguments against short selling present themselves:

(a) It tends to depress prices.

(b) There is a temptation to keep on selling after prices have fallen. Short selling may be used to disorganize an already dangerous and panicky market.

(c) Professional speculators, the only ones who sell short, do not necessarily confine their efforts to stocks which should sell lower, but attack two or three active securities, thus tending to upset the whole market.

But, balanced against arguments just given there are the following arguments in favor of short selling.

(a) No human being can undertake to say whether short selling tends more to advance or lower prices in the long run. Every short seller must buy. The man who buys, sells later. The man who sells short must buy later. It is only a question of sequence, and there is no normal element involved in that. The ordinary buyer is a free agent; he can change his mind, withdraw at any time, or stay out of the market. But the short is compelled to buy or go bankrupt. It is an absolute commonplace of Wall Street that the stocks in the strongest position are those with a large short interest, because every one knows there is bound to be support which cannot be withdrawn. The short seller never backs out, altho future-delivery contractors in other lines of trade often do.

(b) Shorts buy when support is most needed—when prices are low. They sell when prices are high-

est or at least they try to. Thus extremes are curtailed. When stocks are topheavy the shorts try to sell. In other words, they supply stock when the demand is most urgent, just as they make the strongest demand for stock when there is an over-supply. Short selling takes the sharpness out of nearly every movement. It distributes losses over a period of time on the downward side. It shifts the risk from investors to professional speculators. It provides a stepping-off place all the way down. It spreads the loss over a wider surface. It prevents a sudden slump from a high price to relatively no price at all. These statements are amply proved by the gradual decline in New Haven stock, in which there has been plenty of short selling, as compared with the sickening slumps in the shares of Boston and Maine leased lines, in which there was little if any short selling. Dr. Henry C. Emery, a leading authority on speculation, declares that short selling performed the same function in the '90's in the case of Atchison. On the other hand, where there is an active demand for stocks for any reason, the advances are far more rapid if there are no bold spirits to sell short.

(c) Far more harm is done by putting stocks too high than by driving them too low. More money is lost on the bull than on the bear side. Panics come from over-doing and not from under-doing. There are laws to punish those who circulate rumors to depress bank stocks, but there are no laws to punish the man who circulates a false rumor to put stocks up.

Most persons prefer the bull rather than the bear side, and there are plenty of manipulators to take advantage of human nature. Thus there are a hundred false rumors that a stock is going up, to one that it is going down.

Every time a stock goes down the bears are blamed, like the ogres in the fairy tales. This is silly and every sensible man knows it. The shorts, or bears, are needed, just as a minority party is needed.

(d) Much of the objection to short selling comes from the fallacy that high prices are always beneficial. It may be just as advantageous to buy cheap as to sell dear; therefore, it may be just as desirable for the community to have a force that depresses prices as it is to have one that raises them, altho the real function of short selling is to eliminate extremes—at one period it depresses prices, and later it advances them.

(e) Any sweeping prohibition of short selling would cripple the investment share markets; a large part of the technical short selling at present is not for the purpose of taking advantage of lower prices at all. A man in Chicago telegraphs his brokers in New York to sell one hundred shares of stock which he has with him. He sends the stock by express but until the certificates arrive the brokers are short. When receivership for the St. Louis and San Francisco Railroad was first rumored, a flood of selling orders were received in New York from London, Antwerp, Berlin, and Paris. To execute the orders brokers in New York had to borrow stock to deliver, and re-

main short for a week, until the steamers arrived.

(f) Short selling is a necessary adjunct of the odd-lot business, the least speculative on the exchange. Odd-lot brokers buy and sell on the Stock Exchange in hundred share lots, the regular unit of trading, and then break up these lots into one, ten, seventeen, or any other number of shares, for investors who desire to buy. Small investors do most of their buying when the market is falling, and if the odd-lot broker first buys and then sells to the investor, with the market falling all the time, he loses all the time. But by selling first and buying afterwards (short selling), he avoids loss.

The practice of short selling often affords a means of hedging. What the uninformed consider speculation is often a safeguard, or hedge, against risks which have to be taken. Naturally this is not an amusement for amateurs to engage in. Short selling is serious business and is for professionals. Stocks may be cornered or almost cornered and the short may be squeezed; but he is no more foolish than the man who buys something that he cannot pay for.

REVIEW

Contrast a margin transaction in stocks with that in other lines of business.

Under what circumstances would you find it desirable to trade in securities on margin?

How does an advance or a decline in the value of the security affect a marginal transaction?

What is the legal relationship between a broker and a customer in a margin transaction?

State the various steps in a short sale.

Give the arguments for and against short selling.

CHAPTER VIII

BANKS AND THE SECURITY MARKET

1. *Amount of loans to brokers.*—The fact that a large part of all dealings in stocks is carried on with borrowed money, or on margin raises the interesting question: Where does this money come from? In brief, the brokers who in the aggregate supply vast sums to their customers, usually obtain it from the banks. There are no published data to indicate how extensive a business this is, but it is so large that it forms one of the most important financial activities in the country.

The amount of loans made to brokers on "call," which is only one of three ways in which brokers negotiate, has been estimated all the way from seven to one hundred million dollars outstanding at any one time in the New York market. In a single day as much as $50,000,000 has been lent on call on the Stock Exchange floor, while the total lent directly by the banks to brokers off the floor is unknown.

Another way of finding the size of this business is to note the extent of speculative stock transactions, the majority of which are carried on margin. Taking an extreme case, we find that in a single year, 1906,

more than forty-three million shares of Reading stock were "sold" on the Stock Exchange and hardly more than three million shares were transferred on the books of the company. While many investors who pay for their stocks in full do not have them transferred on the companies's books, most investors do take this precaution and it is safe to infer that the bulk of the sales which did not result in transfers were margin operations and therefore required borrowed money. As Reading stock sold at an average price of perhaps $70 a share in 1906, the enormous total of money involved, even after making every conceivable allowance, is apparent. Reading was and is only one of scores of active stocks.

It is safe to assume that customers do not supply on the average more than ten to fifteen per cent of the money required to carry thru a margin operation, leaving the remainder to be supplied by brokers. In some cases the broker is able to supply the entire sum out of his own resources. In the majority of instances, however, a bank is the usual resort, the broker using the stock which he has purchased for his customer as collateral security for the loan.

2. *Source of brokerage loans.*—It must not be supposed that money lent for this purpose comes from any one source. Much of it is supplied by wealthy corporations with surplus funds available for temporary investment. The United States Steel Corporation, for example, has had at one time more than $100,000,000 in ready cash. The General Electric

Company, the Singer Manufacturing Company and many other large corporations likewise have big sums available in cash; rich individuals, as well as many wealthy estates, also have lent as much as $20,000,000 at one time to brokers.

Despite such activities, nearly all the money finds its way thru the channels of the big New York banks. Not only do these banks lend their own surplus funds and those of wealthy individuals and estates, but for many years they have lent the funds of thousands of banks located in other parts of the country, altho this practice has been somewhat altered by the Federal Reserve Act. In testimony before a Congressional committee [1] in 1913 it was brought out that the chief lenders at that time were J. P. Morgan and Company, First National Bank of New York City, National City Bank of New York, Lee Higginson & Company of Boston and New York and Kuhn, Loeb & Company. Several of the trust companies in New York City have grown enormously since 1913, and are large lenders to brokers.

3. *Kinds of loans to brokers.*—Loans to brokers are of three kinds, time, call and one-day unsecured. The first named are for a definite period of time, stated when the sum is borrowed. With a time loan the broker is certain that nothing will be required by the bank until the end of the stipulated period. Normally time loans cost more than call loans, but the

[1] Report of the committee appointed pursuant to House Resolutions 429 and 504 to investigate the concentration and control of money and credit, Feb. 28, 1913. Pujo Report, Page 56.

rate fluctuates less. They are usually issued for thirty, sixty or ninety days.

The call loan, as its name implies, is much more temporary. Consequently the broker must use much good judgment in his borrowing. If he takes on a number of time loans at say 5 per cent when call money is at 2 per cent, he may seem to use poor judgment; but if call money suddenly rushes up to 10 per cent, his foresight is obviously rewarded. If money rates promise to advance in the future, a broker does well to rely on time loans; whereas if money gives indication of remaining stationary it is evident that he does well to take on call loans. In other words the proportion of a broker's time and call loans is determined by his judgment of the money market conditions. The rate on time money remains the same thruout the life of the loan, whereas the rate of most call loans is "renewed" from day to day.

4. *Call loans.*—Call or demand loans are theoretically callable at any time. In the New York market, however, certain customs have developed governing the conditions under which the banks may call loans. The call is usually made in the morning and the money must be repaid, not during the same day but the following day by 2:15 P. M., when the broker receives back the collateral he gave in support of his loan.

It has also become an unwritten rule that if a loan made one day is to be called on the following day it must be called at or before 1 P. M. If not called by that time the understanding is that the loan will run

until at least the second day following. In practice call loans are at least one day loans, and may run on for many weeks or months. There are instances on record where banks have allowed call loans on gilt edge securities to run for years. Indeed, in one case a call loan ran for forty years.

5. *How brokers' loans are made.*—The business of making loans by the bank is carried on in two ways. The first is by direct connections with the stock brokers, and the second by the use of middlemen or money brokers who act as intermediaries between the lenders and the borrowers. Most of the loans are made by so-called money brokers, who are to be found at a regular place in the board room where loans are made. The rate for call money varies from day to day. Sometimes it is very low, while again it soars to almost prohibitive heights. The charge which is made, however, is definitely established on the Stock Exchange and is quoted upon the ticker tape just as are the security quotations.

The bank officer as soon as he ascertains at the beginning of the day how much he has at his disposal for lending, will call in one of the money brokers whom he regularly employs and ask him to find a market for it. In most cases the broker serves the banker gratuitously because it gives him a standing with the banks and makes it easier for him to get time loans, thereby making him of greater use to his customers and consequently increasing his profits. The money broker then takes his place on the floor of the Ex-

change and offers his loanable funds to the brokers. All that he really does is to find some one who desires to borrow money and then to agree with the customer upon the rates which shall be charged, in a way exactly like that used for the sale of securities.

When the transaction is closed the money broker hands to the stock broker a slip containing the name of the bank for whose account the loans are made. The money broker's duty is now finished and all further arrangements are made with the bank.

6. *Collateral for the loan.*—The call loan is negotiated upon the security of collateral which is furnished. In the transactions between the stock broker and the money broker nothing is said about the character of the collateral which is to be furnished. This is a matter, however, which is of the utmost importance to the bank. When the broker comes to make his loan he offers collateral as security. The banker will carefully scrutinize this collateral. All the securities deposited must be satisfactory and must be "good delivery" according to the rules of the Stock Exchange—that is to say, they must be in good form and there must be nothing which would cloud or raise a question concerning the holder's title or his ability to transfer them to subsequent buyers.

As collateral, the banks look with disfavor upon stocks and bonds which seldom change hands because it is difficult to find a buyer quickly for such securities when they are offered for sale. Active securities are preferred to those which are inactive because in

a panicky market, when stocks are rapidly declining, all banks are forced to drop huge quantities of collateral upon the market in order to protect themselves. Their contracts with the brokers are such that at any time they can either demand immediate repayment of the loan or an increase in the amount of collateral which is furnished for its security; in case neither request is honored, the bank will immediately sell the securities thru some broker upon the Exchange, in order to dispose of them before a fall in prices will carry their value below the amount which the bank has lent upon them. It is of the utmost importance, therefore, that the bank assure itself of a ready market for the collateral which it holds, not only in good financial weather, but also when the stress and storm of a panic are at hand. The rule deciding the value of a security in the mind of a banker, therefore, is not what it will sell for under good conditions, but what it will bring under adverse conditions. It is, therefore, the price obtainable under the greater pressure of a rapidly breaking market that decides in the mind of the banker the value of a security as collateral. In the past, bankers usually discriminated against the stock of manufacturing companies at least to the extent that they would not make a loan upon collateral consisting of industrial stocks alone but this condition has recently been changed. If they do by chance lend on stocks of this kind they will often charge a somewhat higher rate of interest, or they will ask a much larger margin than the customary ten or twenty

per cent. In many cases, however, the brokers give collateral which consists of both railroad securities and industrial securities. In the case of United States Government bonds, which are considered so secure and their market so uninterrupted that passing conditions have little effect upon them, bankers as a rule require a smaller amount of margin.

7. *Banks and speculation.*—In an ordinary market there are millions of securities purchased and held on speculation. While these are regarded as belonging to the speculator who has bought them, they are in reality in possession of the banks which hold them as collateral for loans they have made upon them. The money lenders and bankers, therefore, have the largest amount of money invested in speculative securities; and a considerable proportion of this money, it must be remembered, consists of surplus funds of the country banks.

So-called country banks, which include not only those in rural districts but also those in towns and cities having but a small population, have during a large part of the year, surplus funds for which they cannot find a profitable investment. The surpluses of the farmer, the merchant and the manufacturing company have given the country banks deposits in excess of the demand for money. This is particularly true in the agricultural districts of the middle west and south where the banks have difficulty in finding a sufficient quantity of three and four months' promissory notes to keep their funds employed. On the

other hand the banks in large reserve and central reserve cities, particularly those in New York, are almost always in the market for borrowing the surplus funds of the country market, either upon time or call —that is, for a certain period of thirty, sixty or ninety days, or with the understanding that the money will be returned immediately upon demand. The interest paid for these surplus funds is usually low, averaging about 2 per cent. The country bank, however, is willing to invest its surplus money in this manner, for if no other use can be found for its funds, the low rate is attractive. A very large percentage of this surplus money goes to New York.

8. *Securing the loan, "over-certification."*—Suppose a broker has purchased $100,000 worth of stock for a customer. He contemplates securing an $80,000 loan from the bank on this stock. In order to negotiate the loan he must have the stock in his possession so as to be able to offer it as collateral at the time the application is made. On the other hand, however, before he can get possession of the stock from the seller he will be called upon to make payment in full. In the meantime it is probable that the broker will have a balance in bank which is much too small to enable him to draw a check for the amount of the purchase price of the stock. Here is a gap which must be bridged in some way. The broker must get the money and it is only the banks which can supply it. Without some arrangement to meet this situation the whole business of speculation would

cease. Until a few years ago this gap was bridged by the practice of over-certification. Under this arrangement when the broker was called upon to pay for the $100,000 worth of stock, he drew upon his bank a check for $100,000 to the order of the firm from whom he had purchased the stock. This check was sent to the bank where the broker kept his account for certification. This was a practice which was quite common in all banking communities.

Certification consisted of a formal indorsement of the check by the bank guaranteeing that it would be paid when presented. It was intended to be a certification by the bank that the broker had sufficient funds on deposit to meet the check when it was presented. This guarantee was affixed by the cashier or paying teller of the bank, who endorsed the check across its face certifying that the signature was correct and also that the bank was willing to pay the check upon presentation and identification, or when it came thru the clearing house. This process is explained in greater detail in the Text on "Banking." The broker's balance was perhaps only $25,000, nevertheless the bank had certified a check for $100,000. This was called over-certification and was simply one form of the great system of credit existing in the banking and brokerage business.

The practice of over-certification amounted to a temporary loan. To secure this privilege from the bank, the broker entered into an agreement which provided, that in return for a certain minimum bal-

ance which the broker kept at all times, the bank would over-certify his checks up to a certain specified amount. It was also understood that as soon as the stock was secured from the seller, it was to be taken to the bank and offered as collateral for a call loan. The temporary loan which the banker had made by the over-certification was then transferred into a regular call loan. This practice of over-certification is now largely extinct. It existed for many years in direct violation of the National Bank Act, which provides:

> That it shall be unlawful for any officer, clerk or agent of any National Bank to certify any check drawn upon the Association unless the person or company drawing the check has on deposit with the Association at the time an amount of money equal to the amount specified in said check.

In spite of the provision of the law and the punishment which is provided for its disobedience, over-certification went on for years. The magnitude of the practice can be judged from the fact that in a single year it is estimated that more than fourteen billion dollars of checks were over-certified in this manner.

9. *One-day unsecured loans.*—At the present time the bankers and brokers escape the law by a practice which in reality is little different from the former one. The broker who desires a certified check for an amount in excess of that which he has on deposit will go to the bank and present his own note for discount, drawn to himself and indorsed only by him. This note is made payable the same day on which it is presented and it

is understood that it will be taken up before the close of banking hours by the broker, who will deposit the collateral which he has purchased and make call loans for the amount of his indebtedness. The bank discounts this note and places the proceeds to the credit of the broker. This gives him a balance on the books of the bank equal to, or in excess of, the amount for which he has asked certification. The officers of the bank are therefore relieved of the necessity of overcertifying his checks, for the broker's balance is now equal to the amount for which he desires certification.

In spite of the apparent laxity of this arrangement very few losses have resulted. The banks are extremely conservative about extending the privilege and before doing so make rigid investigations. They must have intimate knowledge of the broker's character, his judgment and his business methods; if he fails to meet the standard in any particular the privilege is refused. In the second place the bank stipulates that the broker must keep a minimum deposit—for example, $50,000—in order to have the privilege of making one day loans to the extent of one million dollars. They count upon having the use of this $50,000 at all times, thus making the customer provide at least a portion of the reserve which must be held against his deposit. The banks pay no interest to the brokers on their balances, and charge no interest for one day unsecured, or clearance, loans, as they are sometimes called. They are also known as day-to-day loans.

Finally, it is understood that the broker must make his deposits at the bank as frequently as he receives checks in payment for the securities which he sells. Frequently he makes deposits six or seven times a day. As a result the broker, while he has received a large unsecured loan, is on the other hand, receiving at frequent intervals, deposits representing payments from firms to which he has sold securities.

The practice of over-certification still exists to some extent in the case of state banks and trust companies. In this class of institution the prohibition against it is not so strict and the state banks therefore continue the practice. Two large brokerage failures a few years ago have made the banks more careful than ever. In these cases the United States Supreme Court held that the banks were not preferred creditors. Several of the national banks no longer make one day unsecured loans.

10. *Interest rates.*—When money is plentiful call loans yield a rate that fluctuates around 2 to 3½ per cent. Here the law of demand and supply clearly operates to determine the amount of business to be done. Occasionally when money is scarce, the rate rises considerably higher than the figures quoted and causes embarrassment in financial circles. When the interest charges are high there is a tendency for business to decrease.

Three terms are employed in connection with the trend of rates. If the rates are normal, that is to say, range from 1 to 3 per cent, call money is "easy"; it

becomes "firm" when it rises to 6, 7, 8 or 9 per cent. If call money proceeds higher, the word "stringent" is applied.

Call loans sometimes jump to 100 per cent or higher. For a few minutes during the height of the panic of 1907, call loans were not to be had at any price. The President of the Stock Exchange rushed across the street to J. P. Morgan's office and said that if money was not forthcoming immediately the Exchange would be obliged to close, or brokers would fail in a wholesale manner. Thru J. P. Morgan's influence a banking syndicate was formed at once and within a few moments the brokers were able to obtain $25,000,000.

When rates rush up to 100 per cent or more it is only the few weaker brokers who pay the highest figures. The more far-sighted ones have some time previously borrowed enough time money at lower rates to enable them to do business. Some banks will not lend to brokers above 6 per cent, regardless of what the prevailing rates may be. If they have no money to lend they withdraw from the market, but they never charge more than their fixed maximum.

The reader might be led to believe that a high rate of interest benefits the banks, yet the contrary is often true. The banks' resources available for lending purposes consist in considerable part of large deposits of individuals or corporations. It is obvious that when the interest rate rises, perhaps to 20 or 25 per cent, the latter can derive greater profits by withdrawing

their funds from banks paying 3½ to 4 per cent and lending them directly to willing speculators and brokers. Consequently it is to the interest of the banks to keep the rate down so that it will not encourage the withdrawal of individual or corporate resources.

11. *Renewal rates.*—Call-loan interest rates are usually subject to change, according to market fluctuations. If, for example, the bank agrees at 11 A. M. to lend a certain sum of money on stock given as collateral at, say 2½ per cent, and if by two o'clock the market rate rises to 3 per cent, the bank immediately proceeds to notify the borrower that a 3 per cent rate will be charged. The statement would read thus: "If agreeable, we mark your loan of $10,000 dated February 16, 1916, as renewed at 3 per cent from this date." If this is satisfactory to the person concerned, he merely stamps the perforated slip attached to this statement and sends it back to the bank as an indication of acquiesence.

12. *Weaknesses and services of the call-loan system.*—The practice of lending money on call to brokers has been much criticized. That funds from all parts of the country should be absorbed by stock speculation seems wrong to many persons. No doubt much of the sentiment which led to the passage of the Federal Reserve Act received its impetus from this criticism. Curiously enough the operation of the Federal Reserve Act, far from curtailing the amount of money available for brokers' loans, has thus far had the opposite tendency. This is due to the fact that

with the much smaller reserves required under the Act, the banks have larger funds available for the purpose.

It is the purpose also of the Federal Reserve Act to build up a market in bills, or discounts, similar to that which existed in London before the war, in order to furnish temporary investments for banks other than call loans. It is doubtful, however, if any short term investments are safer for banks than call loans. The reason money flows to Wall Street from all parts of the country is simply because the stock market furnishes at all times the opportunity for plenty of loans which are quickly convertible into cash. A country bank prefers to send its surplus loanable funds to New York to be lent to a broker rather than let a farmer or merchant or contractor have it, for the reason that these business men cannot repay the loan in ten days if necessary, whereas the broker, as a matter of course, repays it when demanded.

Call loans furnish the banks with a safe means of using surplus funds, the great advantage being that if regular customers need or desire money the call loans can always be cashed in at once. Unlike nearly all other bank investments, call loans can be cashed in without loss, trouble, ill feeling or expense. They are completely liquid, which is a great essential in the banking business.

13. *Effect of money rates on stocks.*—Possibly the relationship between stock speculation and the banks is too close. Certainly the stock market depends very

largely upon the banks for existence and in turn the banks possibly depend too much upon the market. This relationship is a most important force in causing changes in stock prices. When money is easy, prices naturally rise and when rates become firm they tend to fall. Brokers and speculators naturally take an intense interest in the condition of the banks and the rates for money.

Aside from the quoted rates, the surest indication of money market conditions is contained in the weekly statement of the bank Clearing House in New York and of the Federal Reserve Bank.[1] In normal times the statement of the Bank of England is also of importance. The relationship between money rates and speculation is also discussed later in this book.

While many forces operate to influence money rates, the one which most commonly engages the attention of stock operators has to do with the seasonal influences, especially the flow of currency in the autumn to "move" the crops.

[1] See also the Modern Business Texts on "Banking," p. 164.

REVIEW

Who supplies the money for security transactions?

What different kinds of loans are available for brokers?

What would you offer as collateral for the loans?

What is your opinion of the present practice which involves the money of persons who never saw Wall Street in speculative transactions?

What was the danger in over-certification?

What do you understand by "easy" money?

CHAPTER IX

QUOTATIONS AND NEWS SERVICES

1. *Value of news.*—Wall Street is the world's biggest cash market for news. The quickest and most accurate news is absolutely essential to this vast money whirlpool where men speculate in stocks, grain, cotton and other commodities. Even the uninitiated have some idea how exceedingly delicate and flexible are the great markets and how easily the trend of prices changes in either direction as unfavorable or favorable news becomes known. Thus it is the business of the speculative operator to learn as quickly as possible what is going on in the world. If time is money, so is news.

Thus it comes about that Wall Street is as hungry for news as a famished wolf for a woolly victim. To any one visiting the financial district this eagerness displays itself immediately. "What do you know?" is the common greeting, and the question does not refer to health or individual affairs but to national and international intercourse.

The sources of information upon which the speculator relies are by no means haphazard or occasional but, on the contrary, are as accurate and regular as the ingenuity and intelligence of man can make them.

2. *The ticker.*—The most important single agency engaged in the spreading of news in and about the exchanges is the ticker. It is a marvelous electrical typewriter worked from the headquarters of the companies that rent the tickers to subscribers. It prints a narrow strip or ribbon of paper known colloquially as the "tape." The tape is not confined to the Stock Exchange nor to the Wall Street district. It is used both by members of the Exchange and by outsiders. The New York Produce Exchange, the Chicago Board of Trade, the New York Coffee and Sugar Exchange and the New York Cotton Exchange each have tickers of their own, giving the actual prices or "quotations" made on these exchanges and distributed thru the country. Each system is operated by a separate company but all are conducted on a similar plan and with a common purpose. There are about twenty cities outside New York that have their own ticker services.

The ticker seen in banks, in brokers' offices, in hotel lobbies and in other places where those who follow the market congregate is a machine about four feet high, in the form of a column or square pillar topped by a clockwork-like contrivance and usually covered by a glass dome. Within this dome is a spool of narrow paper ribbon which feeds itself into the printer, and upon which the machine operates like a visible typewriter. After the printing by telegraphic conveyance of the first quotation the spool

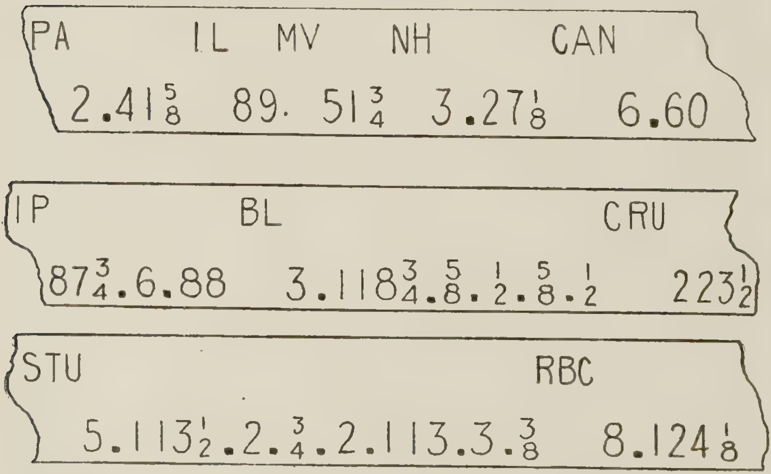
slowly revolves to make room for the printing of the next quotation. Near the ticker is placed a basket into which the ribbon of paper or "tape" gradually falls as the price quotations continue to come in.

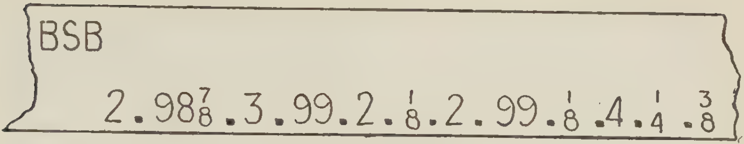
3. *Abbreviations of quotations.*—The Stock Exchange endeavors to give the utmost publicity to operations which take place on its floor. The ticker transmits within a fraction of a minute the news of sales that occur on the Exchange and within another fraction of a second this news appears upon the blackboards in brokers' offices in practically every city of any size in the United States. When it is realized that over 1500 stocks and bonds are quoted on the ticker the necessity for abbreviations is apparent. It would be inadvisable, from a financial viewpoint, as well as impractical, to spell out in full the names of the securities traded in. It is estimated that about 225 characters appear on the tape per minute, yet in a very active market the quotations are often several minutes behind the market. The rapidity with which the quotations appear after transactions are made on the Exchange is nothing short of marvelous. Mistakes, however, do occur occasionally but they are quickly corrected.

To those unacquainted with the tape, it appears to be a meaningless conglomeration of letters and figures but to the broker and professional speculator it is as clear as A B C. The following are the abbreviations of a few of the active stocks.

A T T	American Telephone & Telegraph
B O	Baltimore & Ohio
C R U	Crucible Steel Co.
D H	Delaware & Hudson
E	Erie
G	Consolidated Gas Co.
H R V	International Harvester Co.
I L	Illinois Central
K P	Kelly Springfield Tire Co.
M P	Missouri Pacific
N	Norfolk & Western
P A	Pennsylvania R. R.
R	Reading Co.
S P	Southern Pacific
U	Union Pacific
W X	Westinghouse Electric & Manufacturing Co.

The following is a section of the ticker tape:





It reads as follows:

Pennsylvania R. R. 200 shares at 41⅝; Illinois Central 100 shares at 89; Midvale Steel & Ordnance Co. 100 shares at 51¾; New York, New Haven & Hartford R. R. 300 shares at 27⅛; American Can Co. 600 shares at 60; International Paper Co. 100 shares at 87¾; 600 at 88; Baldwin Locomotive Works 300 shares at 118¾; 100 at 118⅝; 100 at 118½; 100 at 118⅝; 100 at 118½; Crucible Steel Co. 100 shares at 223½; Studebaker Co. 500 shares at 113½; 200 shares at 113¾; 200 shares at 113; 300 shares at 113⅜; Republic Iron & Steel 800 shares at 124⅛; Bethlehem Steel Class B 200 shares at 98⅞; 300 shares at 99; 200 shares at 99⅛; 200 shares at 99; 100 shares at 99⅛; 400 shares at 99¼; 100 shares at 99⅜.

Other abbreviations besides those for the stocks themselves are used for the correction of errors, for offers without bids, or bids without offers, also when a sale is not reported in its proper order, to distinguish the amount sold and the price paid when they are so nearly alike as to cause confusion, to indicate three-day contracts, options and so forth. A word and phrase book and a complete list of abbreviations is usually fastened to the stand upon which the ticker rests.

From the activity of the ticker, the character of stocks appearing upon it, the amount of units of the

deals, the prices, the variety or lack of variety of stocks dealt in, the order of their appearance and other ticker signs which are soon learned, one may get an almost complete picture of the market, indeed the nearest approach to it that anyone who is not on the floor, newspaper reporters not excepted, ever gets. Tickers are used even on the ground floor of the Stock Exchange itself and brokers cluster about them, and then rush to the various posts again to make more deals, the quotations for which they read in the ticker a few minutes later.

4. *Quotation companies.*—How is the rapid printing of price quotations made possible? On the floor of the exchange brokers are buying and selling continually. Uniformed reporters engaged by the exchange, fly hither and thither to secure information as to the sales made, the stocks involved, the quantities sold and the price obtained. Upon getting the information the reporter immediately rushes to one of the four telegraph stations placed at convenient intervals on the floor, from which the message is sent to a gallery where there are employes of the ticker companies. Two companies only are represented; the New York Quotation Company is owned and managed by the exchange itself primarily for the purpose of benefiting its own members. It gives out figures to about eleven hundred tickers, located in "the Wall Street district," which in this case means south of Chambers Street. The other company is a subsidiary of the Western Union Telegraph Company,

known as the Gold and Stock Company. It supplies quotations to persons all over the country who are not members of the New York Exchange. The Exchange attempts to determine who shall and who shall not receive these quotations, in order to prevent their falling into the hands of bucket-shop keepers and other undesirable persons, but the whole subject of its right to control their sale is constantly being fought in the courts.

Another function the ticker performs is that of acting as time keeper. A minute before the limit is reached the words "Hammonds Time" appear on the tape, followed by fifteen clicks. At the end of the fifteenth beat it is 2:15. The ticker thus serves as a valuable reminder and regulator to those who are continually in a state of mental excitement and worry and who are apt, thru their preoccupation, to forget their obligations. On the surface this may seem unimportant to the novice as it requires years of experience to appreciate the value of minor details of which this is an illustration.

Another interesting detail regarding the tickers is that while the Stock Exchange collects the quotations and puts them out on the tickers, it assumes no responsibility for them. They are neither official nor guaranteed. If they were "official," the officers of the exchange would hardly have a moment free from testifying in court in disputes over stock deals.

5. *News tickers.*—Somewhat similar to stock quotation tickers are the news tickers which are owned

and controlled entirely by different private companies. As the title indicates, news is the primary consideration with these tickers. Declaration of dividends, amalgamations, and mergers, election of directors and officers, financial conditions, internal and external, money rates and a myriad other facts are disseminated by this system.

The news tickers are located in most of the larger cities including New York, Chicago, St. Louis, Boston, Philadelphia, Baltimore, Cincinnati, Cleveland, Washington and Buffalo. The paper used in them is for obvious reasons considerably wider than that used in the stock ticker, so that the news ticker is known as the "broad" or "page" ticker. Its work is rapid and accurate and it is a practically indispensable instrument to brokers and speculators, for not only must current prices be known, but the circumstances which exert a powerful influence on the movement of prices must be taken into account. An excerpt from the news ticker is given on page 183.

6. *Bulletin service.*—Hardly less rapid is the dissemination of news by means of the bulletin service. Only a limited number of cities have this facility. In New York City there are two, Boston has two and Philadelphia, one. About every half hour during the period of business activity, from 9 A. M. to 3 P. M. these bulletins come out with information on the many subjects treated. On page 185 is a reprint of one of Dow, Jones & Co. news bulletins.

Page tickers, bulletins, and certain evening and

STOCK MARKET

PAPER STOCKS CONTINUED IN DEMAND AND INTERNAL PAPER MADE A NEW RECORD HIGH BEFORE END OF 1ST HALF HOUR AT 88 1-2 - AM WRITING PAPER PFD GOT UP TO 60 1-2 - NEW CONTRACTS BEING LET BY INTERNL PAPER CO ARE AT MOST FAVORABLE PRICES FROM STANDPOINT OF INTERNL PAPER - WITH GOVT RESTRICTIONS COMPANY PROBABLY EARNED 25 DLRS A SHARE FOR COMMON STOCK IN 1919 - WITH GOVT RESTRICTIONS REMOVED AND COMPANY MAKING ITS OWN PRICES IT IS EASY TO IMAGINE THAT EARNINGS IN 1920 MAY RUN AS HIGH AS 40 DLRS A SHARE FOR JUNIOR ISSUE

AM INTERNL RESPONDED TO THE ARTICLE BY DOW JONES & CO MAKING NEW RECORD HIGH ABOVE 120

SINCLAIR SOLD ABOVE 48 SHORTLY AFTER THE OPENING - CORPORATION IS GETTING GOOD RESULTS FROM ALL ITS ACREAGE IN TEXAS KANSAS LOUISIANA AND OKLAHOMA ESPECIALLY FROM GARBER DISTRICT IN OKLA

STERLING OPENS LOWER

DEMAND STERING OPENED 3 78 1-4 OFF 1-2C - LIRE CHKS OFF 6 CENTIMES AT 13 26 - SWISS CBLS 5 56 FR PER DLR PESETA CBLS 1930 STKHLM 2165 BELGIAN CBLS 5-- 10 70 MARKS 0204 VIENNA 0060

STERLING DEM 3 78 1-4 CBLS 3 79 1-4

FRANCS DEM 10 77 CBLS 10 75

LIRE DEM 13 26 CBLS 13 24

GLDRS DEM 37 1-2 CBLS 37 5-8

morning financial newspapers are all published by the same companies, known as "news bureaus." Thus the same news is used in all three forms of publication, appearing as a mere flash of the essential facts on the ticker, in fuller detail in the bulletins and naturally most complete of all, in the papers.

These reporting companies operate with great rapidity thru the employment of many reporters on a single detail. If directors of a certain railroad company are to meet at noon to declare an important dividend, the financial news bureaus will detail several men to the job. One man stands outside the meeting, another at the end of the hall, another at the nearest available telephone. Days beforehand arrangements are made to obtain the use of a telephone close to the directors' meeting room and this is held open to the news bureau's office from perhaps ten or eleven o'clock on. By this practice and by the use of relays of men it is possible to get out on the tickers the news of some event or action within sixty seconds of its actual announcement.

It is difficult to conceive of the consummate perfection reached by the news service of Wall Street. On a certain day of each month on the dot of noon, Western Union time, a clerk in the offices of the United States Steel Corporation hands to reporters on the other side of a railing a statement of the amount of the company's unfilled orders. The news tickers which stand in the offices of hundreds of

DOW, JONES & CO.

THE WALL STREET JOURNAL — NEWS BULLETINS

ELECTRIC PAGE NEWS TICKER

44 BROAD ST., NEW YORK — Telephone One Broad

Friday, May 4, 1923 — No. 116

U. S. GOVT. WAR AND TREASURY BONDS

Range of U. S. Govt. War and Treasury bonds from 10:00 to 2:45 o'clock follows:

Fractions represent 32nds. For example, 101 1 means 101 1/32

$1,000	Bonds	Open	High	Low	Last	Up	Off
60	3½s	101 7	101 8	101 6	101 8	1/32	..
128	First 4¼s	97 20	97 24	97 20	97 24	3/16	..
642	Second 4¼s	97 19	97 20	97 17	97 18	1/16	..
516	Third 4¼s	98 10	98 14	98 8	98 13	3/16	..
819	Fourth 4¼s	97 24	97 26	97 23	97 24	1/16	..
146	Treasury 4¼s	99	99 6	99	99 6	6/16	..

STOCK MARKET

Call money advanced to 5% in the late afternoon compared with the renewal figure of 4½%. But this development failed to check the rally in progress in the general list, which proceeded to the close. In the final dealings a number of industrial leaders reached their best prices of the day. American Can was the leader of the recovery, snapping back to 89¾, up more than two points from its early low. Pittsburgh & West Virginia continued the outstanding feature of the railroad group, reaching a new high on the movement in anticipation of early establishment of a $3 dividend rate.

TWIN STATE GAS & ELECTRIC CO.

Twin State Gas & Electric Co. for year ended December 31, last, reports gross earnings, $1,351,396, compared with $1,174,455 previous year; net after taxes, $503,432 against $413,163; balance after charges, $237,506 compared with $151,655.

UNITED DYEWOOD CO.

De Witt Clinton Jones was elected vice president of United Dyewood Co. to succeed A. S. Blagden. Other officers were reelected.

REG. MANHATTAN SHIRT COM. DIV.

Manhattan Shirt Co. declared regular quarterly dividend of 75 cents on the common, payable June 1, to stock of record May 15.

bankers and brokers thruout New York City print the figures anywhere from one to two minutes after twelve! The directors of the Standard Oil Company of California met one day in San Francisco and declared a dividend. Their action was wired to New York by the San Francisco representative of a Wall Street news agency and wired back to a broker's office in San Francisco within fifteen minutes.

7. *Newspapers.*—Naturally the cheapest and most widely used sources of Wall Street quotations and news are the financial pages of the daily newspapers. Much of the financial news that appears therein is adapted from the news bureaus, while on the other hand the agencies get many of their suggestions from the general daily press. In the same way the morning and evening papers get many suggestions from each other. Each paper has its own clientele and its own method of treating the news.

This is not the place to describe in detail all the papers which give news of interest to business men who trade in stocks or commodities. It may be well, however, to mention among the daily newspapers the *Wall Street Journal, New York Journal of Commerce, Financial America, The New York Commercial, Boston Transcript,* and the *Boston News Bureau.* There are also numerous weekly and monthly publications, the leading weekly being the *Commercial and Financial Chronicle.*

The important so-called "manuals" containing information about corporations are Moody's, Poor's and

the Manual of Statistics. Card systems along the same lines are the Babson system and the Standard Statistics Bureau of New York. There are also a number of "services" published dealing with transactions on the Stock Exchange.

Furthermore, there is the enormous output of "literature," booklets, circulars and letters from brokers and investment bankers, nearly all of whom maintain so-called "statistical" departments. The mass of facts, rumors, information, "tips," advice, "write-ups" and miscellaneous printed matter concerning stocks and commodities traded in on the exchanges is beyond all belief and calculation. In his "Work of Wall Street," S. S. Pratt declared that one-fifth of everything published relates to business, and it may be added that most of it has some bearing upon the movement of prices on the exchanges. One estimate places the commercial and financial articles and reports in the daily, weekly and monthly press at the annual equivalent of 275,000,000 medium-sized books.

REVIEW

From what sources can we derive up-to-the-minute news concerning financial operations?

How important are these sources to the broker?

What is the function of the ticker?

Make up a list of all the abbreviations of stocks you know. Compare the accuracy of your list with the financial page of a newspaper.

Compare the service of a news ticker with that of a bulletin service.

CHAPTER X

THE CURB MARKET

1. *Origin of the curb market.*—The leading stock markets of the world had their beginning in the city streets. For nearly a century securities changed hands only on the sidewalks and in the coffee houses of Exchange Alley in London. The "coulisse," the name applied to the curb market of Paris, had its origin on the Rue de Quincompoix. On busy days it overflowed into the Place Vendome and the gardens of the Hotel de Soissons. The New York Stock Market was born in 1792 in the street. The brokers met under a button-wood tree at what is now 60 Wall Street. Up to 1820 they traded in the street but at that time some of the leading brokers commenced to meet in the Merchants Exchange Building, corner of William and Wall Street. There were a number of them who refused to do their trading indoors. It was these brokers who may be considered as the real forebears of the present New York Curb. During the Civil War the curb market was in William Street between Exchange Place and Beaver Street. Trading extended from 8 A. M. until 6 P. M. and often darkness did not terminate the activity, for the traders resorted to the Fifth Avenue

Hotel when natural light was no longer available. Between the years 1880 to 1900 the Curb Market was located in front of the Mills Building on Broad Street, and from 1900 up to June, 1921 was conducted in front of the Wall Street Journal Building on Broad Street.

The vast expansion of business and the consequent great increase in stocks and bonds during the last century resulted in the world's chief markets for such securities leaving the streets for splendid exchange halls. Methods of trading became more and more regulated with the increasing importance of the business but there has always been felt the need for an "outside market" without such stringent restrictions and regulations. Consequently in New York till recently, in Boston, London, Paris and other financial centers, the old-fashioned street broker survived.

2. *The New York Curb Market.*—Until the summer of 1921 one of the most picturesque and instructive sights for a visitor to the metropolis was the New York Curb Market. The photograph on the next page gives a good idea of the market as seen when active. There are, however, two elements lacking—color and noise. Curb brokers or their representatives assembled in the middle of the street for trading, irrespective of weather conditions or traffic. The most striking wearing apparel abounded but there was a reason for it all, not because it was esthetic, as might be supposed if we were to see these same personages strolling within the environs of a Greenwich Village or an Arden, but because it was intensely practical.

Each firm had its own kind of hat so that its representatives could be identified by a clerk from its office windows (sometimes as high as the tenth floor of surrounding buildings). This enabled communication between them to be carried on more quickly. Messages were transmitted partly by messengers, by shouting, by lowering of paper memoranda with strings but, mainly, communication was effected by a deaf-and-dumb or wig-wag system. Most firms had their own signal code which was jealously guarded from other firms. But with all these silent signals the successful curb broker needed an exceptionally good lung power, for the trading hours were from 10 A.M. to 3 P.M. and he had to make himself heard among this shouting, howling mob. To the uninitiated this market appeared to be meaningless, but to one accustomed to curb trading the various shouts had much significance. There was almost as much system on the Curb as on the Stock Exchange but its operations were less restricted and safe-guarded than those on the Exchange. The Curb gradually improved in this respect as restrictions and safe-guards were put in force. The Curb market had no offical ticker system yet there was a company which installed "tickers," the quotations of which were written in script on a broad tape and, by means of a "telautograph" process, were made to appear simultaneously wherever the reproducing instruments were installed.

The area within which trading was supposed to be conducted was marked off by means of iron standards

© *Underwood & Underwood*

THE NEW YORK CURB MARKET

and ropes, but the market constantly overflowed its supposed boundaries. The "Curb" had no legal rights upon the street, except upon police suffrance, but its economic function was so great that the police overlooked the fact that it technically constituted a public nuisance by blocking traffic of all kinds on a very important street. It was only on severely stormy days that the Curb was driven off the street. Ordinary bad weather did not affect the trading one way or the other.

3. *Operation of a curb transaction.*—The underlying principles of a sale or purchase on the New York Curb were similar to those on the New York Stock Exchange. Let us see what actually took place when one desired to buy a stock traded in on the Curb. If Mr. Smith of Philadelphia decided to buy Submarine Boat Stock he gave an order to his Philadelphia broker, who might be a local representative of a New York Curb firm or of a Stock Exchange firm. In the first instance his broker would wire directly to the headquarters of his firm which would probably be situated in Broad Street. In the latter instance, he would wire his New York office and they in turn would communicate the order to a curb house. Smith's order for Submarine Boat would be sent immediately to the curb broker's clerk stationed in one of the windows on Broad Street overlooking the Curb crowd. The clerk would locate "Tom," the firm's street representative, probably by his scarlet or vivid green hat, attract his attention by shouting and signal the order

to him by finger signs. Tom would at once hasten to the spot where Submarine Boat was usually traded in and shout his bid. Another broker having an order from a customer to sell Submarine Boat would rush in and offer his shares. The two brokers endeavored to strike a bargain. Tom and the other broker would make out comparison slips which verified this transaction. The following business day the stock would be delivered to Tom's firm which would hand over a check for it. This concluded the transaction. It will be noted that delivery of curb stocks was not effected thru a clearing house (as in the Stock Exchange) but directly from one broker to another.

Hard bargains are driven on the Curb because of the narrow basis on which trading is done. On the New York Stock Exchange, minimum price fluctuations are 1/8 of $1 per share, but on the curb market all stocks selling below $1 per share are quoted in cents per share; those selling between $1 and $5 fluctuate by a minimum of 1/16 of $1 while those selling at $5 and over fluctuate by 1/8 of $1 per share.

4. *Now an "indoor" market.*—Prior to 1908 the curb market had little if any organization. That year the late E. A. Mendels formed the New York Curb Agency. He was at first merely known as the dean of the curb fraternity, then as "curb agent" and finally as Chairman of the New York Curb Market Association which came into existence in 1911. The Association started to consider in 1916 the question of going "indoors," partly because of its increased prosperity

and also because of the desire of the better element to rid itself of the evils inherent in a free-for-all market. The outbreak of the Great War postponed action but it was finally consummated in 1921.

On June 27th, the "Curb" moved indoors. It now occupies a splendid six story structure fronting on Trinity Churchyard, but it still retains the official title of the New York Curb Market. The building provides substantially the same facilities for doing business as the New York Stock Exchange. Trading is carried on at "posts" located over the floor. On either end of the board room, rising in tiers, are rows of traders' desks, set in pairs. Each desk is provided with a dial with three buttons, which flash signals of red, white and green. When an order from a broker is received over the wire, a signal is flashed to the trading post where the board member is operating. A company of uniformed pages, stationed in groups about the floor, provide quick messenger service. Ample machinery for recording sales of securities, together with the establishment of a ticker service, assures the investing or speculating public accurate and speedy information on quotations and sales volumes.

5. *Relation of the Stock Exchange to the Curb.*—Altho the Stock Exchange has no direct or official authority over the Curb, more than three-fourths of all the business on the Curb is transacted by clerks or members of Stock Exchange firms, or originates with them in behalf of themselves or their customers. In every city, members of the organized stock exchanges

are forbidden to belong to any other exchange in that city and when the Curb left the open and went into a building another exchange was created. The New York Stock Exchange, for example, prohibits its members from trading on, or in any way affiliating with, other stock exchanges in the City of New York. Article XX, Section 4 reads thus:

> Dealing upon any other exchange in the City of New York or publicly outside of the Exchange, directly or indirectly, in securities listed or quoted on the Exchange, is forbidden; any violation of this rule shall be deemed to be an act detrimental to the interest and welfare of the Exchange.

6. *Organization and membership.*—Memberships consist of two classes, regular members and associate members. Only the first class have full privileges of the Curb Exchange, the most valued of which is that of trading on the floor itself. The initial fee for regular members is $500, and annual dues do not exceed $400. Membership has been limited to 550 persons. The Curb has continued to expand until it is now second only to the New York Stock Exchange. It possesses a staff of governing officers and committees consisting of a chairman, secretary and treasurer, a governing committee and committees on arbitration, listing, complaints, memberships, etc. Rules and regulations are rigidly enforced and correspond, in essence, to those of the other exchanges.

Associate members pay an initial fee of $250 and annual dues of $50. They are not permitted to trade on the floor of the exchange but they enjoy a prefer-

ential rate on commissions charged for all orders executed for them.

The Curb does not maintain a separate department for trading in unlisted securities; listed and unlisted alike are bought and sold at the several trading posts. This differs from the former organization of the New York Stock Exchange which had maintained an Unlisted Securities Department, until the entire department was finally dispensed with.

7. *Listed and unlisted securities.*—The listing requirements must necessarily be more lenient than those of the Stock Exchange. The Curb often deals in new projects which have not commenced business. It also deals in securities which have not been issued but are likely to be and furthermore it has been known to deal in things that never existed. Among other things, however, the Curb Market Association requires upon listing a security the names, addresses and banking references of all officers and directors, title and location of the company, its product, the place of incorporation, the transfer agency and registrar at New York, date of the annual meeting, the fiscal year, the amounts and par values of stocks and bonds authorized and outstanding, dividends paid, when declared and where payable, etc. An oil company listing its securities must state whether it is a project or a developed property. Oil and mining companies must supply maps of the property and an engineer's report or a certified copy. All companies must give a complete financial statement of their con-

ditions to the secretary when required. The fee for listing is $100.

Stocks that are listed are known not to be fake concerns. The information which is required is available if any one cares to see it. Unlike the Stock Exchange there are on the Curb a number of securities dealt in that are not listed. Indifference or unwillingness on the part of companies to list their securities does not necessarily indicate that they are fake concerns. A notable example of this fact is that of the Standard Oil group. There may be such a thing as being so prosperous that one wants only his friends to know about it. This was the general impression in regard to the Standard Oil Company and some of its subsidiaries before they sought and obtained admission to the New York Stock Exchange.

8. *Functions of the Curb.*—The listing requirements of the New York Exchange are so stringent that many meritorious companies are unable to meet them. These companies need a market thru which their securities may be distributed, and have found it in the Curb Market. It has been the one great open market-place where any one or any company with stocks or bonds to sell may negotiate with buyers. The Curb has been called the "training ground" of American finance, for the majority of the well known stocks on the "Big Board" were originally launched on the Curb.

An open market, free from all restrictions, draws to itself the security issues of a great many industrial,

mining and miscellaneous enterprises. Some of these enterprises are established and their securities entitled to a good investment rating, others are in the first throes of getting on their financial feet after incorporation and their securities are commensurately speculative, while others are only in the promotion stage and their stocks are bought solely as "prospects." Such stocks are traded in on a "when, if and as issued" basis; deliveries are made when the engraved certificates are ready to be distributed. While the requirements for listing safe-guard the public from many fraudulent and get-rich-quick schemes, it must not be supposed that listed securities on the Curb necessarily have greater value than many of the unlisted.

There are many well known and exceedingly valuable stocks that are not listed on any exchange, the liquidation of which could never be effected with the facility that only a central market affords, were it not for the Curb. There are stocks which are tightly held and have no market, or at most a narrow one, because the chief owners do not care for one. The facilities which the Curb offers make it possible for the small holder to turn such stock into cash whenever he likes, while such transactions record reasonably accurate quotations for such transactions.

The Curb serves another purpose in that it permits trading in securities the par value of which is as low as ten cents. Mining corporations, especially, issue stocks ranging from ten cents per share to twenty-five dollars.

9. *The future of the Curb.*—The change from an outdoor, unrestricted market to the restrictions incidental to moving indoors is in reality a change in our financial machinery for the distribution of securities. We have seen that only members may trade on the floor. In the street, any fake promoter could come to the trading center and make a market for his gold bricks and none could say him nay. Now, if his stock is to be traded in on the floor, it will have to be handled thru a curb member, who has his reputation to think about. Thus we see the reason for going indoors—the closer control of the market thru supervision of those who utilize its distributive facilities. This is further exercised thru limitation of membership, as stated before.

An important feature has been also the desire to purge the Curb of the somewhat unsavory reputation it has had, in order to meet the growing popular demand for stringent state or federal supervision of promotions, security issues, and the operations of the exchanges generally. This trend of opinion is expressed by the increase in "Blue-Sky" legislation. Housing the Curb market was long discussed but was delayed thru the fear—attributed to the New York Stock Exchange—that even if the sheep and goats on the Broad Street Curb were successfully separated, the goats who remained outside would form the nucleus for a new curb market.

Secondary advantages of housing, apart from the obvious protection of the members from the weather,

are the establishment of a ticker service and the possibility of keeping an official record of transactions.

The New York security market now has the Stock Exchange with its very severe listing requirements and its relatively limited number of stocks and bonds eligible for trading and the Curb Market with a certain measure of restriction which is sufficient to change its status from that of an absolutely free, open market. There remains the demand for a market such as the former hangers-on of the Curb enjoyed, and the fact that this "demand" is from that particular element instead of from the general public in no way augurs against the possibility of another market being established in the street. Fake promoters of all types know that when the public is in the proper spirit of optimism and there is plenty of market activity, stocks of any kind can be sold. Experience alone will show whether a second street market, free from all restraint, will be able to grow up and reach a place of prominence rivaling the present Curb.

The public at large fails perhaps to appreciate the importance of the Curb Market. An authority stated that in point of volume of business, the Curb is the second largest market in the United States, ranking second only to the Stock Exchange. During 1917, the transactions on the Curb were eight times greater than those of the Consolidated Exchange, and fourteen times larger than the combined total of shares sold on the Exchanges of Boston, Philadelphia, Pittsburgh and Chicago.

10. *Commissions.*—A definite schedule of commission rates, which may be charged on transactions taking place on the Curb, has been adopted. The rates were increased May 15th, 1919. For securities selling under 50 cents, the minimum rate is $1 per 100 shares; for those selling at 50 cents to $1, the rate is $2; at $1 to $3–$4; at $3 to $5–$5.50; at $5 to $10–$7.50; at $10 to $125–$15; at $125 and over–$20. As is the case in all organized markets the rates that are enforceable at the penalty of expulsion or similar drastic punishment are the minimum. Usually the brokers who trade on the Curb raise the commission charges above this level on the lowest and highest stages in the scale; that is to say, on securities selling for less than $1 and above $200. On intermediate values the rates are usually uniform because of keen competition between broker and broker. The minimum commission on any transaction is $2.

11. *"Over the counter."*—Up to this point we have seen two methods of disposing of securities, namely, on the Stock Exchange and on the Curb. A third method is known as "over the counter" and it is thru this medium that most other securities are sold. The name, "over the counter," is derived from the method by which unlisted securities were originally handled. Modern methods have supplanted the counter by the telephone as a medium for these transactions and it would now be more appropriate to call them "over the telephone" transactions.

It should not be assumed that securities traded in

this manner are of a poor grade, for in fact many of the most gilt-edge securities are handled in this way because investors hold them after having once bought, thus preventing a sufficient market to list them on the Exchange.

Let us see now the actual workings of an "over the counter" transaction. Suppose that Brown desires to buy 10 shares of American Power and Light, preferred, an unlisted stock. He will inquire of his broker what price he will have to pay for the stock. It may so happen that his broker does not handle unlisted securities and in that event the broker will call up an "unlisted trader" who he thinks would most likely have the best market on American Power and Light. The unlisted trader will look at his cards on which he keeps a record of quotations and give the broker the bid and asked price, which quotations indicate the range of the market. Brown's broker then asks the trader what price he can get the stock for. A definite price is stated at which the trader thinks he can buy it. If this price is satisfactory to Brown, the unlisted trader is then informed to go ahead and make the purchase. The trader then will call up other unlisted traders or customers who he thinks will most likely have American Power and Light for sale. When he has found some one who will send him the stock, he informs Brown's broker.

It may often happen that the unlisted trader cannot get the stock directly but will find it thru another unlisted trader. In such instances each trader en-

deavors to "scalp" as much as possible, that is to say, to make as much of a middleman's profit as he can. Sometimes before a transaction is completed it will take a week or more to find the stock or customer for the stock and to come to an agreement on price. It often happens that it is not possible to make the transaction within the same city and recourse must be had to some other city. The principal market of an unlisted security is usually in a city near which the company issuing the stock is situated.

The "over the counter" method of selling securities is sometimes used by corporations issuing stock direct to the public instead of thru a bond house or an underwriting syndicate. Those wishing to purchase the company's securities would present themselves at a specified place, sign a subscription blank, make payment and receive a receipt which will entitle them to the securities purchased when the company makes distribution.

12. *The auction market.*—Still one other method of disposing of securities is by auction sale. Those desiring to sell stocks or bonds will notify the auctioneers, who will advertise the securities for sale in a catalog, which gives a list of the securities that are to be sold on the auction days which usually occur twice a week. The catalogs are sent to those who are on the auction house mailing list. These securities are also advertised in newspapers.

Stocks at auction are sold "flat," that is to say, the price will include the accrued dividend; but bonds are

sold "price and interest," the interest being the amount earned from the date of the last interest payment date up to and including the date of sale. This applies to all bonds except Income and Defaulted Bonds.

There are very good reasons why securities are sometimes sold at auction. (1) Legal requirements in some instances make it the duty of executors and trustees in disposing of securities to do so at a public sale and the stock exchange, according to law, is not a place of public sale. (2) When securities are sold to cancel a debt, the law protects the debtor by requiring the same to be sold at public sale. (3) For securities that are not listed, auction may be considered the best place of sale. (4) Securities of very little value or even worthless, are sometimes disposed of at auction and also (5) when a broker has not the right to sell pledged securities on the stock exchange or because they are not listed, he may resort to the auction.

REVIEW

What are the differences and similarities between the Curb market and the New York Stock Exchange?

Compare the classes of securities traded in on the Curb with those of the New York Stock Exchange.

What are the functions of the Curb market?

Describe the "over the counter" method of selling securities.

For what reasons are securities sold at auction?

CHAPTER XI

BENEFITS AND EVILS OF SPECULATION

1. *Investment, speculation and gambling.*—It is the purpose of this chapter to clear up, as far as a most difficult subject permits, the controversy as to whether speculation is a good or bad institution and whether, if possible, it should be abolished. Before we go into the subject it is necessary to make plain the essential features of the three well-known ways of employing money—investment, speculation and gambling. No doubt the reader already has his own idea of their meaning but the time has now come to define and distinguish them in detail.

The three words are frequently confounded and even considered as synonymous. Indeed, the three acts themselves are constantly being confused. Speculation is a certain aspect, it is true, of the broad term investment. It is often said that no stock is a good investment unless it is also a good speculation, meaning thereby that an investment should have a future as well as a past. In a hearing before the United States Committee on Banking and Currency the late Charles A. Conant, a distinguished economist, was asked, "How much of a twilight zone is there between investment and speculation?" He replied:

A very wide one, necessarily. Some securities that were considered at one time absolutely non-speculative, like a distinguished New England Railroad, sometimes become very speculative. There is nothing sure. As the gentleman . . . said, you cannot give a policy of insurance with investments. You have to take your chances in the evolution of the financial and economic affairs of the world.

Another witness at the same hearing testified:

Many who buy for investment buy partly on credit; a purchase for investment may have in it a speculative element determining the permanence of the investment. It is a common experience to buy for investment and yet sell on an unexpected rise in the market or when an expected rise takes place. It is not a criterion of the investment or speculative character of a transaction whether or not the security is bought partly on credit any more than it is in the case of purchases of real estate. Securities bought with a speculative purpose may be retained as investments. Any statement of the proportion of the transactions that are of an investment as distinguished from a speculative character is merely a worthless guess.

Yet investment and speculation differ as widely in the underlying principles involved as do the words themselves. Let us first get a clear view of speculation and then we can see how it differs from investment.

2. *Speculation defined.*—The word speculation is derived from the Latin "speculare" meaning to spy out, to look out, to observe. This Latin derivation affords the best idea concerning the meaning and real significance of speculation. It involves nothing more or less than the desire of the individual to over-

come the domination of chance and to penetrate the future with a view of profiting by the accuracy of his judgment as to the course of events.

The speculator in his daily operations, is obsessed with one idea which remains permanent and all-dominant in his mind—how he can anticipate or spy out the future conditions of supply and demand. He strives in this way to overcome the inevitable fluctuations of values and is successful in so far as he accomplishes this end.

Speculation is never artificially created. It exists only when property has fluctuating value. Fluctuations cause speculation. It must not be supposed that speculation alone deals in uncertainties. All business is fundamentally affected by demand and supply and these two forces constantly fluctuate. Especially in agriculture, upon which all other industries rest, the supply fluctuates as good years follow bad or vice versa. Among the disturbing factors in other phases of business are fire, incompetency, miscalculation, corruption, depreciation, change of popular taste, new inventions, and wars. Insurance may provide against some uncertainties, but only a few. Thus the professional speculator who has an equipment for his work equal to that of the highly trained business or professional man in reality assumes no greater risks than the farmer, manufacturer or storekeeper. In fact he quite properly assumes smaller risks in any given operation because he is satisfied with relatively smaller gains and losses. The very

nature of his business is to assume those risks and, as in the analogous business of insurance, a large number of risks can safely be assumed only by making each one relatively small.

To overcome future uncertainties is the task which the speculator sets before himself. In theory a speculator is one who is engaged in foretelling the powerful changes in prices, but in practice he puts his information into effect by purchasing or selling commodities or securities. His supposed ability to foretell prices is the foundation upon which he works. Speculation must involve reflection and careful thinking on the one hand and, on the other, the assumption of risk, conscious or unconscious, on the basis of this decision. The profits, if there are any, are the reward for this reflection, foresight, forethought and knowledge of facts. We may distinguish the two relationships, investment and speculation, from no less than seven different points of view. These will now be discussed.

3. *Safety and risk.*—A man is said to have made an investment when the element of safety predominates in the enterprise to which he entrusts his funds. The undertaking is speculative if risk is involved to more than ordinary degree. The danger and greater liability to fluctuation does not make a very strong appeal to every one; but because it carries with it the expectation of a rise and a consequent source of profit, there are found those who are willing to undertake the risk.

Practically speaking, it is often extremely difficult to differentiate these terms very clearly and to state at just what point one relationship merges into another. When is an enterprise sufficiently devoid of danger to call the placing of money in it an investment; and at what point may one unquestionably maintain that the peril to which the capital is exposed sufficiently warrants its being described as a speculative endeavor? To these questions no hard and fast rule can be applied except thru the standard set by expert opinion. The general beliefs of veterans in industry and commerce, men who have learned some lessons in business life thru personal contact and experience, serve as good criteria of the propriety of including the undertaking in one or the other of the two classes.

4. *Income and profit.*—The distinction between investment and speculation leads to the use of the two words, income and profit, as applied to the revenue derived from the respective businesses. The former designates a steady and regular inflow, while the latter implies a return which fluctuates with external conditions. For example let us suppose two men, each with \$10,000. One of them buys United States Government 4¼ per cent bonds and the other puts his funds into common stock in a corporation. One receives a yearly income of \$425, the other obtains a profit which cannot be determined until the fiscal year is complete. Profits on the common stock may in one year rise to 40 per cent on the capital invested

while, in a year of depression or crisis, they may be reduced to a low level or may disappear altogether. In the case of an investment, the individual expects to derive each year a definite sum which is not subject to any substantial changes. But when one is willing to be carried along on the wave of business prosperity, securing a larger sum when business is in a highly prosperous state and a much smaller amount if a financial storm breaks, he counts his varying yearly income as profit. That, at least, is the case when he retains the security. However, the ordinary security speculator does not usually purchase with the intention of retaining control indefinitely. He tries to sell at the earliest possible moment when profit may be realized. Securities are dealt in by him merely for their anticipated increase in value. The increase in them is called profit.

5. *Method of purchase.*—The investor, as a rule, buys securities or commodities outright. The speculator, on the other hand, buys on a margin. Investors may, it is true, occasionally buy "on margin," but speculators rarely buy in any other way. The amount of their capital is limited, but their operations are extensive. Placing small amounts here and there enables them to spread their capital over a wider area of the security market than would otherwise be possible and aids in equalizing their risks. The speculator realizes quite well his liability to ruin and tries to guard against it by "covering" and "hedging."

6. *Ownership of capital.*—Another point of difference between speculation and investment is the nature of the ownership of the sum put into the enterprise. This follows as a direct result of the methods of purchase. The individual who possesses a surplus which he desires to invest does so for the purpose of making it productive. It must not be idle so he converts it into an income-bearing source by investing the whole sum in a way that he believes to be safe and reasonably profitable. On the other hand, the speculator buys on a margin because he does not want to tie up his limited resources by buying outright. He must always be alert and active, prepared to buy at a moment's notice any active commodity or security which indicates a possible source of gain.

7. *Duration of investment.*—While the investor is content with a steady income and tries to avoid reinvestment, the speculator is incessantly changing the form of investment to meet the exigencies that constantly arise. Whenever the speculator believes that prices will rise, he buys and buys quickly. The retention of his purchase hinges on the course of succeeding events. As a rule, buying is a temporary matter with him and his decision varies according as the possibility of gain is close at hand. When indications all point to the advisability of retaining what he bought, no alternative presents itself; the decision is made automatically. When loss must be incurred, he immediately sets out to relieve himself of the bur-

den as quickly and shrewdly as is possible in the circumstances.

8. *Bonds or stocks.*—Investments are usually made in bonds, mortgages and preferred stocks, whereas common stocks are the field of speculation. A bond is in reality a promissory note usually secured by the property of the concern itself. The stockholder, tho he technically owns the enterprise, has no direct voice in its management. This lies in the hands of the directors who have been elected by the majority stockholders. Profits are only secured in the form of dividends when the board of directors votes to this effect. The board may decide to accumulate profits, without declaring dividends and, as long as its action is legal, there is no force on earth to make it act otherwise.

So far the picture is a gloomy one for the stockholder but there is a reverse side to it. The interest on bonds usually ranges from four to six per cent, but in the case of stocks no limit is set. In times of prosperity the income rises very high but in dull times reaches a low ebb. The possibility of enormous gain is considered a recompense for the risk. Since dividends of common stock are thus subject to fluctuation, the prices of the stock are liable to similar variation, thus opening up a great field for speculative efforts. An announcement of large orders in connection with the expectation of handsome profits causes a flurry of excitement among would-be purchasers; the security in question is eagerly sought, and

for a time prices rise until the climax takes place. At this stage, particularly, cool-headedness and sound judgment are needed by the speculator.

9. *Gambling defined.*—All these characteristics serve to distinguish clearly between the two forms of business relationship. But we have to contend with another difficulty which finds its origin in popular confusion of definitions and lack of understanding of details. Speculation is often attacked on the ground that it is merely another form of gambling. How is it distinguished from gambling?

The gambler acts blindly and assumes risks whether the exigencies of the situation require that course of action or not. The speculator, on the contrary, assumes only those economic hazards which must fall to someone's lot in the operation of world trade. Every business teems with risk and chance, and the speculator is best fitted by his training to cope with these elements adequately. It is not a question of an artificial institution; speculation is an inherent aspect of commercial intercourse and must be taken into account, willingly or not. Moreover, speculation presupposes intellectual effort; gambling, only blind chance.

Both gambling and speculation, it must be admitted from the very outset, hinge on uncertainties in the fundamental laws underlying human action. Both, it is true, have a common lucrative purpose. In both cases also, the object nominally purchased is often not actually in the physical possession of the

owner at any given time. Furthermore, in each instance, the method of buying is identical, that is marginal payment. But there is all the difference in the world between gambling and speculation.

Gambling with cards entails a definite, concise loss on the one side and a corresponding gain on the other. Gambling on the stock and produce exchanges is much the same. The gambler is reckless, assumes danger when there is no necessity for doing so, and employs little or no judgment and intelligence in the determination of where his money should be placed.

10. *Method of the speculator.*—In contrast to the gambler, the speculator employs a method. The profit of the speculator does not always imply a counterbalancing injury to the other party. What the normal speculator gains represents merely the difference between cost and selling price. He deals in "futures," for example, and buys up wheat crops from the small or large producers at a certain definite rate per bushel. The contract is a voluntary one and agreeable to both parties. The farmer in this case receives the prevailing market rate for his goods. Prices later, rise, and, if the speculator unloads, he makes a profit. He performs a distributive function. The speculator assures the farmer the receipt of a definite sum and thus removes the element of risk from his shoulders. As recompense, the speculator gets the profits, if any exist, and a loss if the market goes against his expectations.

It must be admitted that in actual practice much of what we may strictly define as speculation is carried on with a gambling intent. Even where the forms are legally those of speculation and all the surface indications are those of legitimate speculation, the intent and the social effects may be those of gambling. The rules of all exchanges forbid gambling as we have defined it.

11. *Evils of speculation.*—The great evil of speculation lies in the fact that persons who engage in it assume unnecessary risks and simply bet on fluctuations. There are too many amateurs in the business, too many unskilled adventurers without either the necessary capital or the mental equipment. The unskilled lose in this field as readily as in any other. They seek in a childish manner to make money without work, either mental or physical.

Possibly this evil of speculation on the part of ignorant outsiders can never be entirely abolished, but it can be greatly reduced. The whole trend of opinion among the leaders of the organized exchanges is that many more safeguards should be established to prevent the "pikers" from taking "fliers."

12. *Excessive speculation.*—The charge is often made that speculation is harmful because of its great extent. A Congressional Committee, known popularly as the Pujo Committee, prepared tables showing that within any given period, certain stocks are "sold" on the Exchange at many times the amount

of those stocks that are actually outstanding. One stock, for example, was dealt in six times over its amount in a single month. These figures are further fortified by the fact that dealings in certain stocks vastly exceeded transfers.

Such figures clearly indicate excessive speculation but there are counter considerations. Commonly these enormous transactions are confined to a few popular securities. It is the same on the London Stock Exchange and also to a certain extent true in Paris and Berlin. The great majority of stocks are never subject to such operations. As far as the fact that more stocks are sold than transferred on the company's books is concerned, it may be noted that many investors fear their ownership may be revealed if their stocks are transferred. In other words many operations, which appear on their face as being wholly speculative, are really of an investment nature.

13. *Effect of speculation on stocks.*—If dealings upon the various stock exchanges of the country were confined solely to the business of investors, it might be possible that a cut in the dividend of an investment issue would result in a hundred selling orders without a single buying order. Conditions upon the exchanges, however, do not follow any such one-sided plan. On any exchange there are always found both buyers and sellers for any stock which is listed. In this way one of the most useful functions of specu-

lation is secured, that of counterbalance. The purchases made by the traders have a tendency to check or overcome the declines and at the same time give to the sellers an outlet for their stocks.

14. *Speculative refinements lead to abuses.*—No sensible person will doubt that great economic services are performed by this elaborate mechanism. But like other human institutions, it lends itself to abuses which arise both within and without the exchange.

It is natural that with speculation made so easy on the legitimate exchanges irresponsible parties should make it still easier off the exchange. Thus we have the bucket shop, where one may gamble in stock or grain quotations without any buying or selling whatever taking place. It is a fungus growth upon the institution of exchange speculation, an abuse and a pest, but one which would hardly have been devised had the speculative machinery not been what it is. On the other hand if bucket shops had not catered to the gambling instinct it is likely that some other institution would have done so.

15. *The bucket shop.*—Like many another word the term bucket shop which we use to designate any place where men gamble on stock prices, by fictitious sales and purchases, has been used in varying senses at different times. Such places are so well disguised that it is very difficult to distinguish them from the offices of legitimate brokers. The bucket shop as we know it always operates in the same field. At one

period it deals mostly in stocks, at another in grain. If killed in one place it breaks out in another, altho the warfare against it gains strength from year to year and ultimately may conquer it.

The distinctive feature of this form of gambling consists in the fact that stocks are not usually purchased or sold for the customer, and selling and buying does not take place with a view to delivery. The intention of the customer is merely to pocket the difference between the price which he pays and the price to which the stock rises. Otherwise expressed, the customer wagers against the bucketer on the price of a stock. The owner of a shop always takes one side of a deal, whether the patron realizes and consents to it or not, and in the long run comes out the winner as is the case in most gambling establishments.

The dealings are simply in profits and losses, not in the securities themselves. As prices fluctuate the differences flow into the pockets of the winners. The interest of the bucket shop is always opposed to that of its patrons, as the profits of the shop are measured by the losses of the patrons. It is an impossible task to beat a bucket shop. Mr. Hill in his book on "Gold Bricks of Speculation" illustrates this fact.

Take, for instance, the \$10 stock trade—which is the most popular deal among the patrons of bucket shops; could there be a more insane bet on the part of the patron? He steps up to the order window, pays in \$10 and "buys" say, ten shares of American Sugar at \$110 a share. If Sugar declines ¾ of a point—to \$109.25—the patron loses his \$10

the 25 cents being the commission charged by the bucket-shop. Sugar must advance to $111.25 in order that the patron may win $10 from the shop after paying the 25 cents commission. I am not an expert in figuring the percentage in games of chance, but it looks to me as if the fool patron was betting even money with the keeper, that Sugar would advance $1.25 a share before it would decline 75 cents a share; in other words, the keeper has 50 cents a share the advantage of the patron on a bet involving a fluctuation in the stock market of 75 cents on one side and $1.25 on the other, or a total of $2, so that the "sucker" starts out by giving an advantage of 25 per cent to the keeper. Or, it might be more correct to figure it in this way: the stock must advance $1.25 a share to permit the patron to make as much as he would lose on a decline of 75 cents a share, the advance being 66⅔ per cent of the decline. It is a question in my mind on a deal of this kind (and there are probably more of these deals, than of any other in bucket-shops) if the keeper has not really a 66⅔ per cent advantage.

The customer of the bucket-shop surely gets the worst end of the deal. When the price of the security reaches the point where the margin becomes exhausted, and one actual change in quotation may do this, the transaction is closed.

It is evident that bucket-shops exist only when they are able to secure the quotations made on legitimate exchanges. Occasionally the bucket-shop is obliged, for reasons to be explained later, actually to buy or sell stocks. But in that case a contrary order is put in for a like amount, so that in no event does the shop carry stocks. Legitimate stock exchange brokers have been known to "bucket" their orders, that is accept the customer's loss or pay him the profit

without any real buying or selling but the punishment on all exchanges is sure and swift if the authorities discover any of this practice.

The majority of bucket shops advertise that stock can be actually delivered, but as their patrons call for delivery only in rare cases, they can afford to buy the stock thru genuine brokers to fill these occasional demands. On the real exchanges not only are all stocks delivered, except where the clearing houses make an offset, but vast quantities of stock are actually transferred every day from one owner to another on the books of the companies. Even where the broker on a legitimate exchange has the gambling instinct he is forced by the rules into an actual merchandising transaction.

The organized exchanges wage relentless war upon the bucket shops and try to put them out of business by preventing quotations made upon the exchanges from reaching the bucketers. This requires the exercise of vigilance and the more powerful of the bucketers resort to endless legal controversies to defeat this aim.

The Federal Government also relentlessly fights the bucket shops and more have been closed by the Government than thru any other legal agency. The basis for Federal action is the misuse of the mails for purposes of fraud. In addition to governmental action nearly all the states have laws prohibiting these concerns.

The test as to whether a business is operated as a

bucket shop or not rests on the ability of the complainant to prove that it was not the intention of the one party or both parties to the transaction actually to deliver the property, but merely to settle by a payment of the differences. Some states make it possible for a business to be so considered if it can be shown that only the proprietor had this idea of non-delivery of property while other states require proof that both parties had such intention.

"The bogus broker and tipster," says Sereno S. Pratt in his book "The Work of Wall Street, "fill the advertising columns with their flamboyant appeals to would-be speculators. Advertising is expensive, but it must pay them. Some of the advertisements of the bogus brokers are indeed masterpieces of art and ad writing." The legitimate brokers will simply advertise their names, business exchange connections and probably recommended securities, but no high sounding phrases are used.

The Governing Committee of the New York Stock Exchange passed the following resolution on February 9, 1898:

> That in the future the publication of an advertisement of other than a strictly legitimate business character, by a member of the Exchange shall be deemed an act detrimental to the interest and welfare of the Exchange.

And on April 26, 1916, the following was passed:

> That it is the opinion of the Governing Committee that, under the Resolution of February 9, 1898, no member, or

his firm is permitted to use "Catch Phrases" or to depart in any way from direct and simple methods of advertising.

16. *Evils of bucket shops.*—In actual practice it is not always easy for a customer to know whether his orders are really being executed or bucketed, altho of course there are very many brokers who are above suspicion in such matters. To make sure the customer need only ask for the name of the broker on the opposite side of the transaction, that is, the one from whom his security was bought or to whom it was sold.

On May 19, 1909, the New York Stock Exchange adopted the following by-law with regard to bucket shop operations on the part of members of the Exchange:

> That any member of this Exchange who is interested in or associates in business with, or whose office is connected, directly or indirectly, by public or private wire or other method or contrivance with, or who transacts any business directly or indirectly with or for, any organization, firm or individual engaged in the business of dealing in differences or quotations (commonly called a bucket shop) shall on conviction thereof, be deemed to have committed an act or acts detrimental to the interest and welfare of this Exchange.

Another of the great evils of the bucket shops is that all the money spent in them by the customer has little or no effect upon the market. The bucketer steals from his customer a most valuable asset, his effect upon the market. If a man buys one hundred shares of a stock he is entitled to the strengthening

effect which his buying has upon the price of that stock. But as the bucket shops buy practically nothing there is no effect.

17. *Effects of speculation in general.*—The great services which speculation performs have been mentioned several times before. In briefest outline they are: (a) removing risk from many classes of producers; (b) steadying and leveling prices; (c) adjusting prices and regulating the flow of commodities between markets; (d) directing industries into profitable channels and liquidating those that are ill judged. Speculation is clearly the most elastic feature of the modern financial system. It takes the edge off panics and famines; for by putting up prices it enforces economy ahead of future want, because the speculators discover a future shortage of grain before the consumer does. It tends also to prevent monopoly.

Speculation, moreover, softens the intensity with which great economic forces work by lengthening the time over which their influences extend. The speculator is accused of being a non-producer, a parasite. It is true that he does not produce goods. His main function is to bring about necessary adjustments in the business world. He hurries up or delays and smooths out necessary processes. Thus he is really a producer of "time utility." As civilization expands and the means of communication increase, speculation has a tendency to destroy itself, because the field of certainty where business can be performed on an intelligent basis is always being widened. Thus,

speculation is not permanent in any one branch of human activity.

18. *Survey of restrictions on speculation.*—Among the earliest attempts to curb speculation, was the enactment of a law in 1707 licensing brokers and making illegal the transactions of unlicensed brokers. A year later, city ordinances were put into effect requiring brokers to give bonds to insure the proper and honest performance of their obligations. After the South Sea scheme had ended in national disaster in England, considerable agitation arose to make impossible another calamity of this kind. The result was Sir John Barnard's "Act to Prevent the Infamous Practice of Stock Jobbing."

The essence of this piece of English legislation is the prohibition of the practices now known as puts and calls, and what was most important of all, of short selling. However, what seemed to be a panacea for existing evils was shattered by judicial decisions. The courts interpreted the law as applying to English public stocks only and this freed from the operation of the statute all foreign securities and all domestic securities not included in the category of "public."

Sir John Barnard's law remained on the statute books, ineffective as it was, until 1860 when it was formally repealed. Seven years later the Leeman Act was passed with reference to the sale of bank stocks. It specified that the number of such certificates sold must be recorded and made known; other-

wise their sale was prohibited. Later, this provision was repealed and at the present time no unreasonable restrictions exist with regard to speculation in the United Kingdom.

19. *Experience in Germany.*—In an attempt to place a curb upon short selling, the German government, in 1892, appointed a commission composed of government officials, merchants, bankers, manufacturers, professors of political economy and journalists to investigate the methods of the Berlin Exchange.

The bill recommended by the commission was rejected by the Reichstag; but that body, in 1896, passed a drastic law. The strong Agrarian party, believing that short selling lowered prices of agricultural products, insisted upon the prohibition of contracts for the future delivery of wheat and flour. Popular opinion also demanded an abatement of stock speculation. The law as passed prohibited all trading in futures in wheat and flour and in all industrial and mining shares. The law provided further that all persons who wished to speculate must register, and that speculative trades made by unregistered persons would be considered gambling contracts and therefore void. Public registry was required in an endeavor to prevent small speculators from assuming risks, when they were unable to stand the losses such operations often entail.

The law failed of its purpose. Few persons registered. The small fry evaded it. Foreign brokers

flocked to Berlin and established agencies for the purchase and sale of stocks in London, Paris, Amsterdam and New York. This resulted in the transfer of German capital to foreign markets, the passing into insignificance of the Berlin Exchange, and a general impairment of the financial standing of Germany.

20. *Why the German law failed.*—Dr. Henry C. Emery commented on the repeal of the German law before the Senate Committee on Banking and Currency, February 11, 1914, and explained why it was ineffectual in carrying out its intended purpose. In his testimony he introduced the following quotation from an earlier statement on his part:[1]

(1) Fluctuations in prices have been increased rather than diminished. The corrective influence of the bear side of the market having been restricted, the tendency to an inflated bull movement was increased in times of prosperity. This in turn made the danger of radical collapse all the greater in proportion as the bull movement was abnormal. The greater funds needed to carry stocks on a cash basis further increased the danger when collapse was threatened. The result was an increased incentive to reckless speculation and manipulation. Says the report of 1907: "The dangers of speculation have been increased, the power of the market to resist one-sided movements has been weakened, and the possibilities of missing inside information have been enlarged."

(2) The money market has been increasingly demoralized thru the greater fluctuations in demand for funds to carry speculative cash accounts. The New York method is held in abhorrence by German financiers, who attribute to it in large

[1] *Yale Review*, May, 1908.

part the wild fluctuations in New York call rates, the frequent "money panics," and the tendency to reckless "jobbery." In proportion as the new Berlin methods approached the cash delivery system of New York, these evils have appeared there.

(3) The business of the great banks has been increased at the expense of their smaller rivals. The prohibition of trading for the account made it difficult for the latter to carry out customers' orders, because the new methods required large supplies of both cash and securities. Furthermore, an increasing share of the business of the large banks came to be settled by offsets among their customers, and the actual exchange transactions became a proportionately small part of the total transfers.

(4) This has a twofold effect. Business within the banks is done on the basis of exchange prices, but these became more fluctuating and subject to manipulation as the quantity of exchange dealings were diminished and were concentrated in a few hands. The advantages of a broad open market were lost. The object of the act had been to lessen the speculative influence over industrial undertakings. Its effect was to increase it.

(5) Finally, the effect of interference, increased cost, and legal uncertainty was to drive business to foreign exchanges and diminish the power of the Berlin Exchange in the field of international finance. The number of agencies of foreign houses increased four or five fold, and much German capital flowed to other centers, especially London, for investment or speculation. This in turn weakened the power of the Berlin money market, so that even the Reichsbank has at times felt its serious effects.

It is apparent that thus far laws to suppress speculation have been failures. The Cotton Futures Act of 1915, the most recent law enacted in the United States to regulate speculation in cotton, is in no sense prohibitive, but is designed to abolish certain purely

technical abuses. Further legislation is more likely to take a similar form than to attempt any general suppression of speculation as a whole. The experience of other countries very largely precludes serious consideration of prohibitive legislation by well-informed governing bodies today.

REVIEW

How do you distinguish between investment and speculation?

How do you account for the stigma which in past years has attached to the term "speculator"?

What in your opinion constitutes legitimate speculation?

What is the test to determine whether a concern is a bucket shop or not?

What are the evils of bucket shop transactions?

What attempts have been made to restrict speculation?

CHAPTER XII

INFLUENCES THAT AFFECT STOCK PRICES

1. *How far is speculation scientific?*—The future is always uncertain, but in so far as future movement of stock market prices can be foreseen, speculation may be made scientific. It is mere truism that man cannot foresee all the details of future events, therefore no system has ever been devised to foretell all fluctuations in prices, and the fate of the stock speculator who believes his method to be infallible is likely to be similar to that of the gambler at Monte Carlo who endeavors by means of elaborate calculations to work out a system of "breaking the bank."

A moment's reflection will show that speculation cannot, on account of its very nature, be reduced to an exact science. In the preceding chapter it was pointed out that as knowledge in any particular field becomes more precise, exact and complete, speculation tends to destroy itself. The same idea may be expressed in a more colloquial manner as follows: If speculation could be reduced to an exact science everybody would be right and there would be nobody left to trade with. In other words, if speculation could be reduced to an exact science—and many fakirs and charlatans pretend that it can—there would

be no risks or uncertainties, and therefore no speculation.

In the first chapter emphasis was laid on the fact that stock exchanges serve as a barometer of future business conditions. They anticipate, or "discount" the swings of trade, the ebb and flow of prosperity. Now if the stock market is a barometer, how can any one pretend to foretell its movements? To discover a method of predicting with certainty the prices of stocks would be like finding an instrument that will predict the movements of a barometer.

Countless forces play upon any large market. Each share of stock bought or sold affects the whole, and who can say why a particular share is bought or sold? Each loaf of bread eaten affects the price of wheat. These considerations are what a great economist has called "the imperceptibles of commerce." Who can weigh them all? The speculator must make a careful study of a large number of conditions that are only remotely connected with the earning power of any company, in order to be able to understand the fluctuations which occur in the prices of its securities. It has been aptly said that hardly an event occurs in the world which does not have some effect upon the prices of securities. With equal truth a statement of the same general nature can be made for all industrial and commercial activities, for the effort to foresee the future and make profit by so doing enters more or less into all business activities. It can be proved that stock prices

do not fluctuate so irregularly but that their general trend, and in certain instances actual prices, can be foreseen, provided the speculator has the proper mental equipment and knowledge. Those who do possess this knowledge and equipment are, however, comparatively few.

2. *Prices and values.*—It will be noticed that stocks vary in price not only from year to year, but from month to month, day to day and hour to hour. It is, also, a matter of common knowledge that stocks which are of the same apparent worth and which pay the same dividends differ enormously in price.

This is not only puzzling to those unacquainted with the stock market but even the brokers are often at sea over the extreme gap between the prices and values. It is no uncommon thing for a stock to move ten points in the course of a day and often greater changes will occur in one or two hours. When one refers to range in prices which occur over a period of a year it is more evident that there exists a lack of consistency between values and prices. Theoretically price and value should equal each other. Price on the one hand refers to the market quotations while value has reference to the worth or income the securities yield. Examples of such differences between values and market prices are not necessarily limited to the stock exchanges but exist in all markets.

The price of a stock at a given time is the result of the interaction of the desires and necessities of buyer and seller, representing demand and supply respec-

tively. Free bargaining takes place in the open market and prices move according as these desires and necessities change from time to time. We have already seen that speculation arises largely from fluctuating property values, and it may be added that fluctuation in the value of property is the underlying, altho by no means the only cause of price movements of stocks.

The prices of stocks are affected by a multitude of complicated influences, but it is safe to lay down the general principle that values do tend to fix prices for periods of time long enough to eliminate temporary disturbances. Price and value do continually tend to approach each other. The real value, the absolute intrinsic value, nearly always remains intangible, indefinable and unascertainable. Nevertheless, as the stock market represents the largest and best single body of collective opinion obtainable in regard to business, we find that the line of prices is never very far from that of values for any great length of time. Thus, during the period 1897 to 1902, the lowest average price of twenty railroad stocks was less than 42, while the highest average price rose to nearly 118 on May 1, 1901. The difference between the lowest and the highest for the period was 76, which represented an increase of 180 per cent. Mr. Pratt uses this as an illustration in substantiation of his principle that this upward movement of stock prices corresponds very accurately to every possible test of value. He points out, for

example, that during this same period the banks increased their clearings by 175 per cent. Furthermore, the value of the railroads, as represented by their surplus earnings available for dividends, after all fixed charges and operating expenses had been paid, increased about as fast as the price. According to the reports of the Interstate Commerce Commission, the net earnings over this period increased from $492 to $1,190 per mile, or approximately 140 per cent, while the dividends actually paid out increased from $484 to $725 per mile. This comparison shows that the increase in surplus earnings available for dividends was not so much less than the increase in price as reflected on the New York Stock Exchange.

3. *Classification of price movements.*—One of the best known classifications of price movements is that of the late Charles H. Dow, one of the founders of the *Wall Street Journal,* who was himself credited with being a very successful speculator. This classification is based on the principle, generally accepted as sound, that in the long run prices are governed by the intrinsic value of the security, and the variations are the result of extraneous influences. Dow's classification is threefold.

(1) The "primary movement"—governed by intrinsic values—which is the most powerful of the three.

(2) The "secondary movement," or the "swing"—

governed by manipulation, by current reports and by the market machinery.

(3) The "tertiary movement," which is the daily fluctuation in the market, is caused by the most trifling circumstances—rumor, the operations of room traders or some other similar influence.

Mr. Dow claimed that the primary movement, or that based on value, lasts the longest and is ultimately the controlling factor in speculation, as it is in investment. The only speculators who have had any long-continued success in the market are those who follow the primary movement. They disregard daily fluctuations and carry their securities with a very heavy margin, or pay for them outright, waiting for the real value of the property to be reflected in the price of the security. Those who gamble upon the daily fluctuations or who stake their hopes upon the success of manipulative efforts sooner or later come to grief.

The primary movement in either direction usually covers a considerable period of time; often it is several years before its effect is consummated. A careful study of the variation in the prices of securities over a period of years shows that at more or less regular intervals, averaging perhaps four or five years, there is a reversal in the prices. Starting from a low point, securities will advance with some degree of steadiness to a high point, and will then decline with more or less suddenness. Altho during the years while the securities are running this range there

will, of course, be many retrogressions, nevertheless the general tendency is unmistakably apparent. These more or less regular intervals of change are spoken of as "cycles" of advancing or declining prices. This subject is further treated in the Modern Business Text on "Investment" and should be referred to at this point.

A secondary movement, or the "swing," may continue for weeks or even months. Prices of securities may be artificially inflated or depressed by the operations of a powerful syndicate or clique the members of which have created unnatural conditions in carrying out a policy for which they have banded together. To follow the operations of such a group is always dangerous. Speculators who are students of conditions and who operate on the basis of what their study of values discloses, are more likely to meet with financial success. Many people lose their money in Wall Street because they base their operations on chance or "tips" instead of on value. Either daily fluctuations or a powerful "swing" will be sufficient to cause financial ruin. The primary movement of prices causes fewer failures than the secondary or tertiary movements.

4. *Technical conditions.*—Stock prices are, in the main, governed by fluctuating values, but once speculation sets in they are often largely determined—for the time being at least—by the laws of speculation itself, in other words, by "technical" conditions. As one authority has said:

The speculator who has bought, may sell in order to close his transactions. When a large number of speculators have bought "long" the market is threatened with a large amount of sales which must sooner or later be made—and vice versa when speculators are generally short, purchases must eventually be made to "cover."

The former condition is called an "overbought" market and the latter an "oversold" market. . . . It is to this development that we must ascribe many of the sharp movements downward in a period of advancing prices and the sharp rallies in "bear" markets.

Experience shows that the price movement in either direction is constantly overrunning itself in this way and reacting, and it is an axiom in Wall Street that reaction is more or less proportioned to the action that it follows. Many people claim that on a fair average reaction will be somewhat about half the action previous.

The reactions that come from these various speculative endeavors constitute the technical condition. Thus, a stock may decline for a while wholly because of speculative or technical considerations, irrespective of any question of value.

In the discussion of speculative or technical conditions we may also include the question of whether the supply of stock in the Street is ample or limited. If there is a small supply in brokers' hands, speculators may easily shove up the price. Of course the existence of only a small floating supply is often attributable to the fact that the stock possesses intrinsic value and has therefore been bought up by discerning investors.

5. *Crop conditions.*—It has already been stated that prices are influenced by a magnitude of compli-

cated influences, but that intrinsic value or earning power tends to fix prices as regards a period of time long enough to eliminate temporary disturbances. The whole body economic may be likened to the internal combustion of a gasoline engine in which every part of its mechanism must perform its function at the exact time if efficiency is to be maintained. If thru some mishap one part should go wrong the whole engine suffers, to a greater or less extent, according to the nature of the trouble. In a similar manner, if there is a total or partial failure of crops, stocks of railroads, milling and industrial corporations will fall in price. A decrease in a crop involves a corresponding decrease in the revenue derived from its transportation, and means less work for the mills. The great volume of the nation's agricultural wealth supplies a very large share of the tonnage of the railroads and affects the securities of numerous other leading industries. This is probably the simplest illustration that can be given of the "general business conditions" that affect stock prices.

The reader will rightly conclude that if, in order to forecast stock prices, it is necessary to survey the whole field of business, he has no light undertaking. He will realize the fact all the more vividly when he knows that these factors are only some of many that must be taken into consideration. Among the important barometers that are used as indicators of the general business situation are: size and conditions of crops, money conditions, railroad earnings and traffic

returns, bank clearings, pig iron production, exports and imports, trend of commodity prices, United States Steel Corporation unfilled orders, building statistics and business failures. Such groups of statistics are consulted and are from time to time published by the leading financial publications. For the purpose of forecasting the periods in the cycle of trade, there is a variance of opinion as to the worth of such statistical data. However, it cannot be denied that accurate statistical data does give us an insight into business conditions for the time being and gives to security owners a basis on which to exercise their discretion as to the future price movements of their holdings.

6. *Money conditions.*—Probably of greater importance than any other factor affecting prices is the condition of the money market. We have already discussed the close relation which exists between the banks and the security market. Brokers and operators watch the money situation with a close eye because the stock market is keenly sensitive to any changes that take place in the money conditions. They keep in close touch with the conditions of the banks with which they have their accounts. A summary of bank conditions is furnished by the various bank statements. The big banks of Europe also issue such statements and these too are very carefully watched by the brokers of our large cities because they are regarded as an index of the money market conditions in the largest financial centers of the

world. The items of loans and deposits are watched with particular interest for the percentage of loans to deposits is considered to be the best barometer to show the contraction and expansion of credit. In this connection the percentage of specie to loans should also be considered, for it is quite possible to have a situation showing a high percentage of loans to deposits and yet the situation may not be serious if the percentage of specie to loans is also high. The danger comes when loans are high and specie low.

It may be stated as a general rule that whenever the loanable funds of the banks are low, higher interest rates prevail for call and time loans. This tends to put a check on stock speculation and bring about the calling of loans by the bankers, thus producing a decline in security prices. When the calling of loans takes place at a wholesale rate or the supply of credit is diminished practically to the point where it is impossible to make loans, as took place in the latter part of 1907, large quantities of securities are unloaded on the market, which causes a slump in their prices. Periods of this kind are designated as panic. In order for a bull market to exist there must be at the outset an ample supply of money and moderate rates of interest.

7. *Gold production.*—The effect which the production of gold has upon prices is a question upon which there seems to be a considerable diversity of opinion. No one disputes, however, that it is a subject of great importance when considering its effect over a

long period of time; but many deny that it is so important when considering only a short period. The consensus of opinion is that the effect of an unduly increasing supply of gold leads to higher prices; overproduction in any other quarter inevitably leads to lower prices. Gold being a fixed standard cannot decline in mint price except by government action, but it does decline in value. That is to say, the flexible prices of things which gold will buy rise to fill the gap. Mr. Holt in his book entitled "Gold Supply and Prosperity" arrives at the conclusion that the value of gold will depreciate as its supply increases, altho probably not in the same ratio and that such depreciation will be measured by a rise in the average level of prices. As a result of rising prices we have higher interest rates and therefore the prices of bonds and most other long-time obligations, which draw fixed rates of interest, dividends or income, will decline to lower levels. On the other hand, because of rising commodity prices and property values the market price of stocks of corporations holding commodities or property will tend to advance.

It is reasonable to admit that an overproduction of gold is one of the factors affecting prices, but to claim that it is the only factor would be illogical. An increase in credits in any form, increased volume of trade, the action of labor unions, increases in population, destruction of natural resources, industrial combinations and many other factors, which tend to

affect the prices of commodities, rates of interest and prices of securities are important factors in the prevision of market trends and stock prices.

8. *Manipulation.*—Another factor which should be considered as affecting prices is manipulation. Probably the most comprehensive explanation of manipulation is this: "Putting up prices by virtue of ability to do so." Manipulation almost invariably conveys the idea of artificiality. It always connotes skilful and ingenious management. It is in a sense an art. Usually a group of men, a pool perhaps, or at any rate interested parties, buy or sell securities or produce in such a way as to give the public the idea that the activity involved in such buying or selling is the result of natural forces. This is the usual meaning of the word, but there are many others. As John G. Milburn, counsel to the New York Stock Exchange, has said:

The term manipulation is one of comparatively recent origin. Like all such terms it is necessary to define it to avoid confusion in its discussion. We get nowhere if it has different meanings to different minds. It has, for instance, been applied argumentatively before this committee to transactions to which it does not at all apply. It is also improperly confused with speculation. It is not easy to say what the meaning commonly attributed to it is, because it is generally used as a term of vituperation rather than as description of a definite class of transactions. Perhaps as accurate a definition as can be had of it is, the giving by the same man or group of men of contemporaneous, or practically contemporaneous, orders to various brokers to buy, and to other brokers to sell, the same security at the market price whatever it may be, from time to time, for the purpose of

realizing a speculative profit, in some cases from an expected or intended rise in the price, and in other cases from an expected or intended fall in the price, the vice of such a system of orders being that their execution may not involve a change of ownership.

9. *Kinds of manipulation.*—Whereas the effect which manipulation has upon security prices may be considered as temporary, nevertheless it is not to be regarded as unimportant. Manipulation in its broad sense includes fraudulent methods of procedure as well as legal methods. When speculation runs to excess it is often incorrectly termed manipulation. The fact that certain stocks are dealt in more than they are transferred on the companies' books is taken as proof that manipulation exists. Such is far from being the case. Professional traders buy and sell "in and out" several times a day, and handle stock much as they would a ten dollar bill. Their intent may be that of a gambler, but that is quite a different matter.

10. *False information.*—The spreading of false rumors of important tips is a means to fraudulent manipulation. There have been countless instances where false rumors or those with only a grain of truth in them have affected prices. Over the circulation of such rumors exchanges naturally have no authority, except in the most obvious and flagrant cases. Speculators at times go to extremes, discard common sense, judgment and reflection and impetuously rush to ruin upon the circulation of a plausible whisper.

Often the spreader of rumors intends to deceive. State laws forbid the circulation of untruths, with

the avowed intention of injuring property, but tho it is a penal offense, conviction is most rare and difficult except possibly where the standing of banks is affected.

11. *Pools.*—A pool is formed by a number of persons uniting or joining their interests for the purpose of buying or selling and thus increasing or depressing the price of one or more securities or commodities. The members of the pool divide the loss or profit. Often the word is used in much the same sense as syndicate. The word "clique" has also much the same significance. A pool in and of itself is simply a joint venture of various individuals managed by some individual or firm who is given the sole authority to direct the buying and selling for the persons in the pool. The practice is of course perfectly proper and is open to criticism only when the methods employed are questionable.

A member of a pool is naturally prohibited from selling or buying for his own account any shares of the stock in question as long as the pool is in existence, and attempts to evade this rule often result in the collapse of the pool and frequently in litigation.

12. *Directors' and officers' manipulations.* The stock exchange is most active in requiring publicity as regards the declaration of dividends, new stock issues, bond issues, and other financial information regarding companies whose shares are listed; but it cannot prevent directors and officers of corporations from declaring larger or smaller dividends than con-

ditions warrant or in otherwise abusing their trust. In other words, there is nothing, and there can be nothing provided in the machinery of the exchanges to prevent corporate abuses and misuse of trust. The destiny of the corporation lies in the hands of its directors who may or may not declare dividends and who may speculate to destroy the value of the company. They may, if unmindful of their trust, secure control of the company by forcing the stock down in an indirect way and buying the securities at a low price. An unscrupulous director, too, will take advantage of his "inside" knowledge and his resulting stock market operations may be included in the term "manipulation."

Should directors take stock market advantages of their knowledge of perfectly proper corporate transactions prior to the rest of the stockholders? Some hold that a director acts in trust for stockholders and should take no advantage, even when the results are harmless from the stockholder's viewpoint. Others say that a director is but poorly rewarded at best and could not afford the time and trouble if he had no pecuniary advantages.

13. *Wash sales.*—The manipulation of stock by means of "wash sales" is extremely rare upon the Stock Exchange. These fictitious transactions are the result of collusion and conspiracy and are both deceitful and malicious. Broker A arranges with broker B to bid high for a stock when A offers it, with the understanding that B will not pay A for

the stock and A will not deliver it. Other brokers unaware that A and B are confederates are misled in believing that a real market exists for the stock. Formerly "washing" was said to be common on the curb. The committee appointed by Mr. Hughes when he was governor of New York, to report on speculation, had this to say on wash sales:

> So far as manipulation is based upon fictitious or so-called "wash sales," it is open to the severest condemnation, and should be prevented by all possible means. These fictitious sales are forbidden by the rules of all the regular exchanges, and are not enforceable at law. They are less frequent than many persons suppose. A transaction must take place upon the floor of the Exchange to be reported, and if not reported does not serve the purpose of those who engage in it. If it takes place on the floor of the Exchange, but is purely a pretence, the brokers involved run the risk of detection and expulsion, which is to them a sentence of financial death.

14. *Matched orders.*—A much more common and important form of manipulation of the market consists in matching orders. This is a practice which deserves careful consideration. It is manipulation in the strictest sense of the word. An operator who desires to advance or depress the price of a stock does so by matched orders. In these transactions he uses different brokers, some of whom he instructs to buy and others to sell; thus the market is given an appearance of activity. In the words of Mr. S. A. Nelson, the well-known writer on Stock Exchange subjects, the manipulator "will cover his tracks with the skill of

an Indian." In most cases the brokers to whom these tasks are assigned are ignorant of the object in view and execute their transaction in good faith. The stock must of course be paid for in the regular way. The purchase of the stock at high prices, however, materially reduces the profits of the operator in his stock market campaign.

From the foregoing description it is readily observed that a sharp line of demarcation exists between wash sales and matched orders.

15. *Corners.*—The promoters of a corner usually aim not only to dominate prices, but also to create a situation in which they can actually dictate terms to the unfortunate persons who have become ensnared in their trap. The corner takes its name, of course, from the fact that the victims are at bay and must meet the terms of their captors. In other words, they are in a corner.

Corners have been engineered in all manner of articles and in reality are commoner in transactions carried on outside the exchanges than in those on the exchanges themselves. Nevertheless it is true that conspicuous corners have taken place on the stock or produce exchanges, but they are few and are becoming rarer. They are especially spectacular because of the plight of the short seller. The shorts, unaware of the secret efforts of those who are engineering the monopoly, suddenly find they cannot meet their contracts unless they pay the prices of those in control. A witness in court once described

a corner as "a . . . combination to prevent people short of stocks from buying them."

16. *How corners are worked.*—Corners have often proved as dangerous for those responsible for them as for the intended victims and very frequently the manipulators reap only financial disaster for their pains. Because of the creation of big corporations that issue an enormous amount of stock, and because of a wide distribution of the ownership of these stocks, the opportunities for cornering stocks are no longer frequent.

To take a hypothetical case, suppose that the issue of B. T. & D Stock is 500,000 shares, of which A and B own 200,000. These two conspire to work a corner. Quietly, and without arousing suspicion, they begin to buy up shares of the B. T. & D. This unadvertised but active buying gradually boosts the price of the stock to such a high point that short selling takes place. That is to say, speculators anticipate a slump from the abnormally high price, and consequently sell. When the shorts are requested to deliver the stock to A and B they find themselves in a peculiar position. They cannot deliver the stock because they sold what they did not own, and the only persons from whom they can borrow are A and B, the very persons to whom they sold. And of course A and B, since they have bought up all the available supply, will not lend stock on the usual terms.

There are only two alternatives open to sellers.

One is to fail to deliver the securities, a method that entails expulsion from the exchange for breaking a contract. The other is to settle at a fixed price determined by the parties to the corner. This amount is known as the "settlement" price. In any case, if the corner succeeds the victims are caught, or squeezed. Usually the manipulators have lulled the suspicions of the shorts by previously lending stocks freely; then, when all is ready they suddenly call in their loans.

17. *Corners in stock.*—Corners may be divided into two classes, those that merely occur thru force of circumstances, without personal contrivance, and those that are the result of personally directed manipulation. A group of individuals may find to their surprise that they control the whole supply of a certain stock at a given time and, realizing the power which this situation gives them, attempt to utilize it. Sometimes this power falls into the hands of an individual. In either case the event occurs without the consequences having been foreseen. Most corners, however, are the result of definitely planned speculation, the promoter or promoters intending to profit by the unique position of the debtors, whom they have forced into an embarrassing situation.

Space does not permit us to treat in detail all the factors which may be considered as affecting stock prices.

18. *Conclusions.*—It is evident that the task of the speculator is a difficult one and many pitfalls beset

his path. To acquire a fair degree of success requires special qualifications and traits of mind. Mr. Woodlock has summarized the desirable qualities of the successful speculator as follows:

> First: The speculator must have a clear idea of what he is trying to do, that is, he must have some clear notion of what he expects the market to do and how he expects to operate so as to profit thereby. This implies original knowledge of stock values, money values, and speculative market conditions.
>
> Second: The more moderate his operations in proportion to his capital, the greater his prospect of ultimate success.
>
> Third: He must have the strength of mind to resist the temptation of cupidity, and the patience to wait until the chances favor him, sacrificing many apparent opportunities for the sake of safety.
>
> Fourth: He must be more vigilant as to his losses than as to his profits, and inexorable in accepting a loss whenever he is in serious doubt as to his position, never allowing a large loss to accumulate.
>
> With such disposition, with continual application of mind and careful study of financial winds and waves, and with abundant capital, speculation can be scientifically carried on as a profession. But it is a most difficult profession to learn—and not an easy way of making money.

It might be added that the speculator must be cool in times of stress and often must make himself oblivious to all manner of verbal and printed advice. If he has too many other affairs to look after, he had better keep away from Wall Street. To be successful in this hazardous and thrilling occupation requires what can be described in no other way than as cool nerve. Otherwise a sanitarium will be the only out-

come. It is perhaps a characteristic of many Wall Street men to be nervous and excited over trivial affairs, but to receive the news of great pecuniary losses and gains with the impassive calm of the proverbial Indian. That is the temperament needed by the market operator.

Special fitness in both character and knowledge is essential to speculative success. The fact that countless persons, many of whom have been successful in other lines, have failed in speculation only proves more emphatically the soundness of this contention.

REVIEW

Can speculation be made scientific? Why?

What is the difference between price and value of a security?

What is Dow's classification of price movements?

What do you understand by the "technical conditions" of the market?

What are the principal factors affecting security prices?

Discuss the importance of crops, money conditions, and gold production as "business barometers."

What are the different kinds of manipulation?

Contrast matched orders with "wash sales."

What do you understand by the terms "pool" and "corner"?

What are the two kinds of corners in stocks? Explain the characteristics of each kind.

What are the qualifications of a successful speculator?

CHAPTER XIII

PRODUCE EXCHANGES AND THEIR FUNCTIONS

1. *Organization.*—The reader will recall that American stock exchanges were private, voluntary, unincorporated associations. Commodity exchanges, on the other hand, hereafter called produce exchanges, are incorporated, but their rules and regulations are similar in most respects to those of stock exchanges. The points of resemblance between produce and stock exchanges will appear one by one as we examine their methods and operations. Produce exchanges are sometimes called boards of trade, chambers of commerce or bourses. In 1909 the produce exchanges dealing in grain and provisions formed an organization known as the "Council of North American Grain Exchanges," the idea being that of cooperation similar to that which prevails in the various trade associations in every other line of commerce. The object of the Council, membership in which consists of delegates representing the exchanges, is:

to increase the efficiency and extent of the usefulness of exchanges trading in agricultural products; to promote uniformity in customs and usages: to facilitate the adjustment of business controversies and differences that might arise between members of the various exchanges in equity; to

encourage the enactment of wise and helpful legislation; to enlighten the general public as to the important service rendered by exchanges in handling agricultural products; to cultivate reciprocal relations between the trade of North America and that of other countries; to obtain by affiliation those greater legitimate conditions unattainable by separate and local effort; and generally, to advance the welfare of the grain trade, its allied interests and all those engaged in the production, handling, marketing and consumption of agricultural products.

Whereas we have shares forming the basis of trading on the stock exchanges, such foodstuffs as wheat, corn, oats, flour and lard are traded in on the produce exchanges. By some authorities the produce exchanges are considered the more important, as foodstuffs are more immediately essential to human life than the corporations whose shares are dealt in on the stock exchanges. The relations of the produce exchanges with foreign affairs are fully as close, if not closer, than those of the stock markets, and their use of statistics, information, reports and rumors of every variety as extensive.

2. *Types of produce exchanges.*—Organized produce exchanges have existed in the United States since about 1850. In Europe, where they are usually called bourses, they are considerably older. On the other side of the Atlantic the Liverpool Cotton Association is of prime importance, and there are also big wheat markets in Liverpool, Paris, Berlin and Budapest. Other markets are the London Corn Exchange, the Manchester Cotton Exchange and the

bourses of Hamburg, Amsterdam and Antwerp. The Argentine Exchange also forms a large market.

Besides the all-important Chicago Board of Trade and the New York Cotton Exchange, the prominent produce markets in the United States are the following: New Orleans Cotton Exchange, New York Coffee and Sugar Exchange, Minneapolis Chamber of Commerce (which as a wheat market ranks second to Chicago), Winnipeg Grain Exchange, St. Louis Merchants' Exchange, Duluth Board of Trade, Kansas City Board of Trade, Omaha Grain Exchange, Milwaukee Chamber of Commerce, Philadelphia Commercial Exchange and New York Produce Exchange.

Altho Minneapolis has the second largest grain market, those in Kansas City, Duluth, New York and St. Louis are important. The New York Produce Exchange deals in many other products, including hay and straw, cotton seed oil, flour, provisions, lard, oil, waxes, fats, petroleum, pig iron, hops, butter and cheese. The exchange also takes an active part in furthering New York's commercial interests and has committees on canals, bills of lading, exports and railroad affairs.

New York is an important export point for wheat and is the third largest milling centre in the country. Trade in flour is comparatively large, and such trading in wheat as takes place is done chiefly by brokers acting for nearby mills. New York has long ceased to be a primary market for grain, the development of

other export points making it less important than formerly.

An interesting feature of the Produce Exchange is the fact that members may send substitutes on the floor for limited periods of time. While the produce exchanges generally maintain a high standard of membership, there are generally less severe restrictions regarding the occupations of members than obtain on the leading stock exchanges.

The produce exchanges of the Middle West have their specialties. Besides its important wheat market, Minneapolis has a large barley market, Kansas City specializes in futures for hard winter wheat, St. Louis in winter wheat and Toledo in red winter wheat, clover and timothy seed. Flax seed is traded in for future delivery in Duluth and Winnipeg.

Produce exchanges represent the highest development in marketing efficiency. The leading commodities of general speculation are wheat and cotton, with corn a poor third, altho the production of corn exceeds that of wheat. Wheat is subject to more speculation than the other grains because its production and consumption are more international in character. Corn is largely consumed where it grows.

3. *Contrast with stock exchanges.*—The main difference between produce and stock exchanges lies in the method of trade. We shall simply note here some of the marked differences between these two classes of markets.

Inspection and grading of the various commodities

corresponds somewhat to the listing of securities on the stock exchanges, but proper analysis of produce requires greater technical skill, the object being to give a commodity a definite grade according to its quality. A definite grade is established and this becomes the basis on which all contracts for future delivery may be made. When it comes to such commodities as tobacco, flour and live stock, each lot of which may have individual value, it becomes impossible to fix a contract grade. In most cases these articles must be traded in on a cash basis and upon personal inspection. Thus we have sales made on a "cash" basis and as "futures." The difference between these two types of contracts consists solely in the time when title to the commodity is to change hands.

It has become an erroneous impression that very little business on the produce exchanges is done on a cash basis. As a matter of fact an enormous amount of trade is carried on in this way. The customary practice is for brokers to display their samples of grain on tables placed on the floor of the exchanges. Trading in "futures" is almost entirely limited to the larger exchanges, while the great majority of the smaller exchanges are essentially cash or "spot" markets.

Contracts for future delivery take place in the "pit" in much the same manner as securities are dealt in on the floor of the stock exchange. The future contract, among other things, makes possible a com-

mon practice known as "hedging" which provides protection against losses thru fluctuations in prices.

Warehouse receipts are used in making deliveries instead of the actual commodities. When a broker buys a certain number of bushels of wheat for future delivery it is agreed that he will accept and make settlement for his purchase on or before the delivery date, at which time the grain must be tendered him. On the other hand, if the broker has sold wheat for future delivery he agrees to deliver at the specified time, that is to say, delivery must be made on or before the last day of the month designated and it is not until then that settlement is made. If either party to the contract is unable to fulfill its terms, that in itself is a confession of insolvency. In this event the contract is bought in for his account on the same basis of settlement as is followed on the stock market.

4. *Warehouse receipts.*—Because of the enormous volume of future trading that is done in both wheat and cotton, the question of the quality of the product delivered on a future contract is of the utmost importance. Warehouse receipts, which are statements issued by storage warehouses, or elevator companies, show that a certain quantity of a commodity has been stored with them. These receipts must represent one or more basic or standard grades—"contract" grades, as they are commonly called.

These receipts issued by the warehouse or elevator companies are what make futures possible, for the

care with which they are issued makes them not only easily negotiable but readily available as collateral security for bank loans; the bankers have the assurances of recognized companies that the specified commodity is on hand. If this were not so, it would be impossible to finance the crops, for the farmers require huge sums of cash every fall.

5. *Inspection and grading.*—Originally all wheat and cotton was sold upon sight; the buyer, after examining the goods, would take them away. But in this country especially, such a system soon became cumbersome owing to the vast area in which these products were grown. Later, business was done by sample. Altho large quantities are still sold by sample on the produce exchange, and even greater quantities outside the exchanges, the grain and cotton industries could not be conducted on the present vast scale without the use of the grading system, with its system of inspection, weighing, warehouse receipts and state supervision. Certainly future trading is entirely dependent upon these aids.

Inspection and grading on the produce exchanges correspond roughly to the engraving requirements regarding stock certificates. In general, the object in any case is to separate grain and cotton into grades, and to make it possible for any one of several grades to serve as a contract which may be delivered upon the exchanges. The idea is, that, once inspection and grading have been properly attended to, any lot, rather than only a specific lot, will go. Of course, if

each lot had to be viewed by both buyer and seller, it would be impossible to carry on future dealings on a large scale.

It is essential that a grade contain grain of as nearly uniform quality as possible and that there should be a great deal of grain in each grade. Otherwise corners will occur. As it is necessary to have many different grades, the problem of furnishing premiums for the better classes of grain, and discounts for the poorer, becomes a vexing question. The Duluth and Minneapolis markets are said to give the greatest satisfaction in this respect.

The inspection and grading system gives to grain and cotton much the same mobility that stocks possess. Of course, it is this system that makes speculation on a larger scale possible. To abolish it would produce most serious consequences. Professor Grover G. Huebner, in his "Agricultural Commerce," gives the following arguments in favor of this system:

Tho much spot produce is sold by actual examination of the commodities, it is a common practice to buy and sell on the basis of samples, or a combination of samples and grades, and sometimes on the basis of grades exclusively. It greatly facilitates the quotation and publication of spot as well as future prices.

It facilitates the storing and handling of commodities. East of the Rocky Mountains, for example, grain is commonly stored and handled in bulk, all grain of a particular grade being stored and handled in the same bins. Without inspection and grading, the operation of the modern grain elevator system would be greatly hampered.

It makes possible the general warrant or negotiable warehouse receipt system. Without systematic grading all grain elevator receipts would have to represent specific lots of grain stored in special bins; or, otherwise, all of the same variety would have to be indiscriminately mixed to the great detriment alike of growers, dealers and millers.

It tends in a measure to protect buyers and sellers from unscrupulous and dishonest practices. Inspection and grading services, particularly in the local or country markets, are not fully carried out, but so far as they are applied, they serve to guarantee that commodity prices shall vary in accordance with the quality or condition of the articles sold.

The efficiency of the inspection and grading system largely determines the size and prosperity of that market. The inspection must be carried on by reliable and competent men, and the grading must be honestly done.

While it has been possible to establish grading for commodities such as grain, cotton and coffee, it has been found impossible to grade with equal accuracy other commodities such as eggs, apples, potatoes and tobacco. In the case of tobacco, etc., it is nearly impossible to keep track of individual lots in the warehouse. Therefore no buyer will accept a certificate of inspection which purports to be a guarantee that the tobacco he buys is of a specified grade.

6. *Hedging.*—We have seen that the grain exchanges function in several ways. They establish uniformity in customs and usages. They promote just and equitable principles of trade and provide for the regulation of storage charges, warehouse re-

ceipts and commissions and for the inspection, grading and weighing of grain. Finally they furnish an organized market where the trading of grain can be carried on.

It is largely because of the existence of the great exchanges that there is an ever-ready or continuous market where great quantities of grain can be bought and sold at a moment's notice. This volume of trading is made possible because of a large group of speculators who serve a useful purpose because if it were not for this continuous market, bankers would be more reluctant to place large loans at the disposal of buyers and producers of grain and cotton, and hedging would be made impossible. It is, however, not simply because of the existence of a continuous market that hedging is possible. The future contract and short selling are also necessary adjuncts to this practice.

7. *Hedging a protective measure.*—The process of hedging consists in matching a purchase against a sale or vice versa, the purchase or sale being made for future delivery in order to cancel any losses that might occur from price fluctuation and thereby protect the trade profit connected with an actual merchandising transaction.

Those who use the market for hedging may be divided into two general classes:

(A) Those who sell the future in order to protect themselves on grain which they own against the falling price, and

(B) Those who protect themselves against a rising price by buying against sales of cash grain, actual grain or flour.

In the first of these classes we find line elevators and country shippers, i. e., independent elevator companies, farmers, cooperative associations and occasionally large farmers as well as the terminal elevator company at market centers. In the second class we find flour mills, shippers at market centers, grain commission houses, and exporters at the seaboard.

Dealing in futures is not confined to those who hedge as there is a class of speculators who are on both sides of the market and who buy and sell as their judgment guides them. The activities of speculators will be considered later.

8. *How hedging is carried on.*—Let us assume that in July a line elevator company, having small elevators at 50 different stations, buys in one day 1,000 bushels of wheat at each station. The following morning, probably at the opening of the exchange, a representative sells 50,000 bushels of September wheat in the pit. The company endeavors to buy grain at a reasonable margin under the future price and sell it as quickly as possible after buying. The margin should cover a charge for elevating and loading the grain into wagons or trucks, conveying it to cars, plus the freight rates to Chicago, a typical market center, to which they are sending the grain. Often these companies have a private wire connecting their larger stations with their Chicago office. In such cases

the grain would be hedged the same day that it was purchased. They also take business for farmers and other members of the community who hedge and speculate. During the grain movement in July, August and September, the volume of trade on the exchange arising in these centers is very large.

At this time of the year the grain will probably be shipped to the terminal market at once. As soon as the grain has actually been sold on the exchange floor to mills, exporters or terminal elevator companies, the line elevator company will immediately remove their hedge by buying a future for the amount previously sold in the pit. Should the price of the future be higher than at the time it was sold, the company will have a loss on its future contract. But, the price of the 'spot' or actual grain will be correspondingly higher and. when sold, will show a profit offsetting the loss on the future transaction.

If the grain was held in a country elevator so that it did not reach the terminal market until September, it would be delivered on their future sale and no purchase would be necessary. In that case the transaction would not be a hedge but simply a sale for future delivery that was completed by actual delivery of the grain.

By following the same 50,000 bushels of cash grain to an exchange floor, let us now assume that it was sold to a terminal elevator company. As soon as they bought it their head trader would sell 50,000 bushels of December future. Now when the cars are un-

loaded the company will have 50,000 bushels in its elevator. The company will make its profit by selling the grain at the purchase price, plus the storage charge, which amounts to 1 cent per month, per bushel, the cost of insurance, and a small margin for protection against a possible decline in the premium or discount at which the spot grain sells in relation to the future market. This is called a spread. The earnings of these companies come principally from storage. The other items sometimes show a profit, sometimes a loss, and therefore offset each other in the end.

Now a flour mill in Buffalo may sell 10,000 bushels of flour in October to an exporter in New York City for delivery in February. The basis on which this sale will be made will be the price of the Chicago December future. The miller knows how much it will cost to move the wheat from Chicago to Buffalo, and to ship it as flour from Buffalo to New York. Therefore, he will simply add the various freight charges to the price of the December future in Chicago and his own profit for manufacturing the flour. As soon as he confirms the sale of flour, he will buy the December future and be protected should the price rise between October and January. If he knew the variety and grade of wheat that would be delivered to him on his future contract he could wait until it was delivered, grind his flour and ship it. But the seller of futures has the option of delivering any one of several different varieties, while the miller must have one specific kind and can not take a chance on getting some other.

He will then send bids to Chicago elevator companies asking their price on the kind of wheat he wants. Perhaps it is #2 red winter. We will suppose that the 50,000 bushels that was carried into the terminal elevator is #2, red winter. The elevator company will accept his bid and sell him the actual grain for delivery at his mill in January. Knowing that this wheat will be there in time to manufacture it for his customer, the miller will remove his hedge by selling out 50,000 bushels, December future in Chicago.

A grain exporter at a seaboard market will protect himself by buying futures for sales for export and selling out the future, removing the hedge after he has collected the actual grain of the kind he wants at the seaboard.

9. *The activities of speculators explained.*—In briefly reviewing the activities of speculators, it may be permissible to comment on the phases that appear to be abuses, namely, operations by those who use the market machinery, which is a public institution, for their own advantage. It is only natural that abuses have crept into the market, but they are due to the human element unrestrained and not to any apparent fundamental weakness in the market system.

"Scalpers" are pit traders who operate on their own account, buying and selling many times during the day, taking a fractional profit or loss on each trade, and calculating on the volume of small profits to net a satisfactory total over the unavoidable losses. Scalpers sometimes make from 50 to 100 complete trades

a day, during active markets, that is, 50 to 100 purchases and as many sales. It is the general custom among them to even up their trades at the close of the market every day, in order that they will not be long or short of the market over night.

Active expert scalpers during a day of many small-priced fluctuations, will make a trade at almost every price change. That is the kind of market that favors them best. They endeavor to follow the trend of the market and may reverse their operations many times a day in an endeavor to go with the drift. A sudden break or advance of several points, such as was not unusual during the first few years of the War, results in big profits or losses, according to whether the scalper happens at the moment to be right or wrong on the market.

The amount of grain traded in by scalpers at a single trade ranges from 1000 to 100,000 bushels. The latter amount is unusual. The most common amounts, when prices are low, are from 5,000 to 10,000 bushels. As scalpers are on both sides of the market, some buying and some selling all the time, and as individual scalpers are buying one minute and selling the next, and furthermore, as almost all trades are "evened up" the same day, the influence of such operations on the market is not as great as might be expected from the volume of trades.

10. *Other professional speculators.*—Under the head of other professional speculators may be grouped all those who are connected with the grain or other

exchanges who trade or speculate. Many of them make a few trades daily. Most of them, however, trade only when the market is active. Some big speculators may not make a trade for weeks, trading only when they think the price will have a big "swing," that is, 20 or 30 cents per bushel up or down.

Some of these professional traders buy or sell when they think the price will change a few cents, semi-scalping it might be called. Still others accumulate small or medium amounts. They will be either long or short 25,000 to 100,000 bushels, with the expectation of making several cents per bushel profit.

This class of trading sometimes causes wide price fluctuations, tho the effect on the average price may be comparatively small. As big lines are not rapidly accumulated, the market effect of buying or selling a big line may be gradual. This may also be the case when big lines are closed out. In abnormal times, such as during the War, unforeseen conditions sometimes force the traders to close out their holdings quickly. In such cases the quick covering of a big line of short grain or the selling of big holdings of long grain may cause a few days' flurry.

11. *The public in speculation.*—By the "public" is meant persons not connected in a business way with the market, who sometimes speculate, usually when their attention is attracted by a big price movement. The public, as the term is usually applied, means inexperienced persons who have no connection with the grain business.

During periods of quiet markets the public is not a factor in the volume of trading; but in active, full markets caused by crop scares, for instance, public participation becomes an influence of importance. A striking instance of public interests in the wheat market was during the several months immediately following the outbreak of the War, when everybody wanted to buy wheat. An unsettled market for a time usually follows public participation in a large way.

12. *Conclusion.*—This completes the description of the classes of traders whose operations make the future markets. The fundamental purpose of such markets is to facilitate the marketing, storing and distributing of grain, and the operations of mills. Speculation is primarily incidental to the hedging function of the market. When speculation takes precedence, the condition becomes abnormal, but the market soon rights itself again. It may be said that scalping and other speculative transactions in grain are not confined to the pit for there are scalpers and speculators in cash grain also, and in all foodstuffs. For many months after the Armistice was signed there was the greatest speculation in all manner of foodstuffs not traded in on any exchange, including even canned goods and vegetables, that the world has ever known. This occurred during a period when wheat trading on the exchange was not permitted.

The greatest beneficial effect of future markets as a result of hedging (the making possible of which is

the market's chief function) are two. They are the prevention of monopoly of cash grain business by a few powerful corporations, and the reduction of cost of handling from the farmer to the miller or other manufacturer to a small margin as compared with the price of handling other commodities.

It is generally conceded in the grain trade that small, weakly-financed dealers would be crowded out by large concerns of great wealth, were future trading and therefore hedging eliminated from the market. The reason is that carrying of unhedged grain would require larger means and greater borrowing capacity than small firms possess.

The cost of handling wheat from the farmer's wagon to the mill door is low as compared with that of handling other raw materials. The low cost is due to the hedging facilities offered by the future market, for by hedging and thus assuring themselves of small profits, grain elevator companies, shippers in the Western terminal markets, terminal elevator companies and milling companies are enabled to work on small margins. Without such protection, in order to guard against price fluctuations, large marginal profits would be necessary.

REVIEW

Contrast the legal status of produce exchanges with that of stock exchanges.

In what respect do the functions of produce exchanges differ from those of stock exchanges?

To what extent do warehouse receipts play an important part in the trading of grain?

What is hedging and what is its purpose?

Discuss the activities of various classes of speculators. In what markets does each class trade?

CHAPTER XIV

THE FUTURE CONTRACT

1. *Futures defined.*—Perhaps the most important feature of the produce exchanges is the prevalence of "future" trading. The great majority of speculative operations are conducted in "futures." Spot transactions not only call for immediate fulfillment and delivery, but their very nature implies the present existence of the commodity in question. With futures such is not the case, as delivery is not called for until some future time. The United States Bureau of Corporations thus defines futures:

> The system of future trading is based on contracts on the part of the seller to deliver, and consequently on the part of the buyer to receive, at a time subsequent to the making of the contract, a certain quantity of the produce at a stipulated price. . . . A future transaction differs from a spot transaction in that the latter invariably represents goods actually on hand or instantly available at the time the contract is made and, moreover, contemplates an immediate or an approximately immediate delivery.

2. *Use of futures.*—Contracts of this nature are common in nearly all lines of trade. For example, a manufacturer will contract to deliver a finished product at a definite future date at a specified price, and contractors will agree to complete a piece of work at some future time. So in wheat, corn, oats,

cotton, coffee and sugar, delivery is made several months after the contract is entered into. Fluctuating prices in these commodities furnish opportunity for speculation and operators buy the commodity, not for the purpose of making use of it themselves, their idea being simply to resell at a higher price. The buying of a commodity and holding it for the purpose of resale is performed in most fields of business endeavor, but it is seldom referred to as dealing in "futures," or regarded as being at all speculative. The market for futures is generally designated as the speculative market. We have already noted, however, that in the practice of hedging, buying and selling for future delivery is done for the purpose of avoiding speculation, instead of endeavoring to profit by a change in prices.

The time for making delivery on future contracts may be any future month, but in the wheat market there are specified months which are considered most convenient. These delivery months are September, December, May and July. The trader always buys and sells wheat or cotton bearing the name of the month. In fact, the term "month" is often used as a synonym for the word "future." Other words that have the same meaning are "delivery" and "option." If one contracts to buy December wheat, delivery will surely be made sometime during that month. Of course, if the buyer has in the meantime resold to some one else, delivery to him will not be necessary.

3. *Future trading and delivery.*—The process involved may be explained by the following simple illustration. A is a farmer who has grain in the process of growth—wheat, rye, corn, oats or other cereal. B is a merchant who approaches A and makes a contract requiring A to sell B a certain portion of his crop at a definite price. Let us assume, further, that the bargain was made in July and that the produce will be harvested in September. Meanwhile B is the legal and practical owner of that portion of the final yield that he has purchased, and he is bound by contract to keep the terms of sale. Several weeks later, B sees an opportunity to sell his September crop to C at an advanced price, and as a consequence he unloads. This process may continue indefinitely, the future crop passing successively into the possession of many persons, and each owner, in turn, selling it to another person to take advantage of a rise in price. When the month of September arrives, the harvesting of the grain that has been sold begins, and that portion which was sold to B is shipped, not to him, but to the last buyer in the series, say M.

4. *The unit of trading.*—Future trading is also known as "contract" trading, because the broker contracts to deliver in the future a specified amount of a specified grade of wheat or cotton. The word contract also comes to have the same meaning as unit, and is used accordingly. The standard unit for speculation in future grain dealings is 5,000 bushels. If a

man wants more he calls out the number of thousands desired. Thus, when a broker wishes to bid on the exchange for 50,000 bushels at \$2.36$\frac{3}{8}$, he merely shouts "$\frac{3}{8}$ Fifty, May." If he does not mention any amount, it is assumed that he wants 5,000 bushels. It is to be understood, however, that any of the grains can be bought and sold in minimum lots of one thousand bushels or multiples thereof. Wheat fluctuates by eighths of a cent per bushel. Thus, wheat at \$2.36$\frac{3}{8}$ means wheat at \$2.36$\frac{3}{8}$ per bushel. Each eighth of a point is equivalent to \$6.25 on a contract of 5,000 bushels.

Wheat is of two general kinds, winter and spring. Winter wheat is sown in the southern middle states belt during September and October, and harvesting is begun in Texas as early as the latter part of May. Spring wheat is sown in April and the harvesting begins in the Dakotas about August.

5. *The future contract.*—When wheat is bought for future delivery the quality deliverable differs according to the varieties, grade and total quantity of wheat handled in the various markets. The exchanges prescribe what grade or grades may be delivered.

The future contract of the New York Produce Exchange is as follows:

New York..........19

In consideration of one dollar in hand paid, the receipt of which is hereby acknowledged have this day sold to or bought of bushels of contract wheat, which shall be either No. 2 Red Winter Wheat, No. 2 Hard Winter Wheat, No. 1 Northern

Spring Wheat, No. 1 Hard Spring Wheat, or (at a discount of five cents per bushel from contract price) No. 3 Red Winter Wheat, No. 3 Hard Winter Wheat, or No. 2 Northern Spring Wheat, New York Inspection at cents per bushel of 60 lbs. deliverable at seller's (or buyer's) option . 19 .

This contract is made in view of, and in all respects subject to, the By-Laws and Rules established by the New York Produce Exchange, in force at this date.

(Signed)

Certain grades are deliverable at contract prices and others at a premium or a discount of from half a cent to five cents per bushel.

6. *Delivery months.*—The trade in May, July, September and December deliveries is the growth of the customs and trade of the same business. Each of these months represents a time when a movement of grain in the country is starting or finishing. In July the winter wheat starts to move from the farmer's hands and the country elevators to the terminal markets. September marks the starting of the spring season movement in the Northwest. December marks the closing of late navigation when grain will cease moving by boat from the large market centers of the Middle West and will go entirely by train. The month of May marks the reopening of lake navigation when all of the wheat in store at the midwest markets moves toward the seaboard and the mills.

For in whatever month a person buys wheat, the first day of that month is the day on which he must be

ready to accept delivery of his purchase, altho it may not be offered until the last day of the month. The seller has the option of delivering the wheat at any time during the month, and altho future trades are often called "options," this is not in reality an accurate use of the term. If a buyer does not wish actually to receive the wheat in the form of a warehouse receipt, he sells in the pit an amount equivalent to that which he has purchased.

When making delivery the actual warehouse receipts or other evidence of grain need not necessarily be transferred each time the contract is sold. The passing of such valuable paper is avoided by issuing a so-called "delivery" or "transferable" notice which informs the buyer that the seller will deliver certain receipts in compliance with the terms of the contract. This transferable notice will pass thru a number of hands before it reaches some one who actually wants the grain. Delivery of the receipts is then made in fulfillment of the contract, as they represent the actual grain.

7. *Quotations.*—It is quite natural that the quotations for futures should be higher than spot or cash quotations. In a previous chapter we have considered in detail such necessary expenses incurred for holding of grain until the month of delivery, as storage, insurance, transportation and also, since most grain is handled on borrowed funds, an interest charge. There may be other factors from time to time that would offset the normal relationship be-

tween the prices of the various delivery months, but these are the basic reasons for the difference in prices. It frequently happens, however, that the price of July wheat is lower than the price of grain for May delivery. This may seem to be contradictory, but in this case we have another factor which must be considered, that is, the new crop which begins to come on the market in July. Whether the price of July wheat is higher or lower depends on the prospective size of this new crop and also on what is the probable amount of the old crop still remaining in the warehouses. Differences in the price of wheat for delivery in the same month in different markets has already been treated in our previous consideration of transportation charges.

8. *Margin deposits.*—Both the buyer and the seller of a future contract have, according to the rules of the exchange, the privilege to require each of the other a margin of ten per cent of the market price. This is done in order to secure the fulfilment of the contract and is of considerable importance, as it may be months before settlement is made. Such margin is deposited either with the treasurer of the exchange, or with a duly authorized bank. The buyer may demand of the seller a margin equal to ten per cent of the market price and furthermore, to keep his margin good in case the market price should rise, it will be necessary for the seller to put up additional margin equal to the amount of the rise. The seller on his part may require the buyer to put up a ten

per cent margin, and if the price should decline, require an additional margin equal to the drop in price. So, in a margin transaction both parties may be required to protect each other with a ten per cent margin. If the price goes up, let us say five points, the buyer would be required to put up a margin of five cents more for each bushel that the contract called for and, at the same time, the seller would be permitted to withdraw an equal amount; and vice versa if the price should decline. These margins are only protection against non-fulfilment of contract and do not in the least affect the delivery price which has been agreed upon.

9. *Short selling.*—We have already noted that one may buy for future delivery and later resell at a higher price with the idea of making a profit. This is true also when selling short; one expects to make a profit by buying at a lower price than that at which he sells, but the process is reversed. The only difference between short selling and the ordinary type of transaction is that the selling is performed before the buying, that is, one sells something he does not possess but later intends to buy at a lower price in order to make delivery and fulfill his short sale contract. Here the short seller makes use of the future contract in order to carry out his speculative purposes. There is no way of determining, when a sale is made for future delivery, whether the seller actually possesses the grain or not. It is known, however, that the bulk of future sales are made by short sellers, that is to

say, most future sales are for speculative purposes. Speculative transactions and short selling have been the source of a great deal of criticism; nevertheless, these factors give the large exchanges that ever-ready feature to which is attributed the many advantages which come to the business world thru organized markets.

10. *Steadying of prices.*—Speculative factors steady prices. Prices are nothing more than the reflection of expert market judgment, since speculators study the crop condition, the supply on hand in the warehouses, the rapidity with which the year's crop is being consumed, and all other information concerning the crop and industrial conditions. Thru speculation their judgment as to what should be the general price level in order to regulate consumption so that the year's crop will be sufficient to last until the following harvest season, is reflected in the crop quotations. Speculation in futures creates a steady and constantly active market for produce and for commodities of all sorts, irrespective of the immediate demand.

If all the farmers were to sell their products at one time it is clear that because of the operation of the law of supply and demand, the dumping of so much produce on the market would depress the price to a ruinous extent. This state of affairs is prevented by the custom of selling futures, which operates to spread or distribute the produce over periods prior to maturity so as to equalize the supply and stabilize

the level of prices. If it were not for future selling, prices would sometimes decline decidedly and monopolists, taking advantage of the temporary situation, would pile up commodities in their warehouses to resell them later at an exorbitant price when the demand for them arose. The proof of these statements is to be found in a study of grain prices. Speculation not only makes prices more or less uniform thruout the year, but also makes their changes less abrupt over short periods of time.

The government has recognized the usefulness of the "futures market" for the economic functions which it performs. However, in November, 1922, the "Grain Futures Act" was passed by Congress, and has since been declared constitutional by the United States Supreme Court. The act gives the Secretary of Agriculture the power to regulate Rate Exchanges and Boards of Trade. Future trading may be carried on only in such markets as are designated as "contract markets" by the Secretary of Agriculture and after conforming to certain regulations described in the law. Many of the provisions described in the law are not so strict as those which the members of the Exchanges now impose on themselves, nor could they be as readily enforced.

The most important regulation forces the Exchanges to accept for membership cooperative associations and allows them to rebate commissions to members of these associations. Thus, every member

of the cooperative association secures the same commission rate as do members of the Exchange, regardless of the size of the association. During the early days of these Exchanges, certain commission houses made a practice of rebating commission to various traders. Many corrupt practices resulted from such procedure. Finally minimum commission rates were established and rigidly enforced by the Exchange.

Another section of the Act prohibits manipulation of prices, a feature difficult of regulation.

The open market for grain which exists really curtails manipulation. While occasionally speculators are able to influence prices for a time, the law of supply and demand is the real influence, and unless the speculator's opinion on price influences are correct, he will lose heavily and prices will be quickly restored to the supply and demand basis.

11. *Arbitraging in produce.*—Speculation thru the medium of the future contract performs still another important service, that of adjusting prices between different markets by means of arbitraging. We have already examined the practice of arbitraging in the stock market. Of a very similar nature is the process in the produce market. The factors which make it possible are the same in the both cases, namely, quick communication between markets, short selling and an ever-ready market.

There are several methods of arbitraging in the produce market; the least complex transaction is where the arbitrageur buys grain in the low market,

and at the same time sells an equal amount for future delivery in the high market, and then ships the grain to fulfill his contract. If wheat is selling in Minneapolis at what the arbitrageur considers too low a price compared with that in Chicago, considering transportation charges, etc., he sees an opportunity to shave a profit. He would buy spot wheat in Minneapolis and at the same time sell an equal amount for future delivery in Chicago. He would then ship the grain from Minneapolis to Chicago and if the cost of the wheat plus expenses for shipping and incidentals is less than the price at which he sold it in Chicago, he would make a profit.

There are, however, ways of arbitraging which eliminate the necessity of making shipment. Arbitrageurs as a rule do not care to handle the actual grain, their purpose being simply to make a profit from price differences. In order to arbitrage without making actual transfer of the commodity a broker may buy a future in one market and sell a future in the other and at a later date close out each transaction in its respective market. His reason for so doing is the same as in the foregoing illustration; he believes there is too wide a difference between the prices in the two markets. If his judgment is correct and the markets resume what should be their normal price relationship he will be able to make a profit. By covering his short sale and selling out his purchase contract, the arbitrageur will make a profit from one set of transactions and suffer a loss

from the other set of transactions. His profit, however, will be greater than the loss that he incurs. Let us assume that in Minneapolis the price of May wheat in December is $1.00 and in Chicago $1.04 and that the arbitrageur made a purchase of May wheat in Minneapolis, and at the same time a sale of May wheat in Chicago. In the course of a few days it may be that the price in Minneapolis is $1.02 and the Chicago price $1.05¾ and he closes out his transactions. He would have made a two cent profit on his Minneapolis wheat and would have lost one and three-quarters cents on his Chicago wheat, thus netting him a quarter of a cent profit. Suppose, on the other hand, that prices had fallen to $.98 a bushel in Minneapolis and to $1.01¾ in Chicago; he would have lost two cents on his Minneapolis wheat, but would have made a profit of two and a quarter on his Chicago wheat, netting him a profit of a quarter of a cent. It will be seen that it makes little difference whether the prices in general are too high or too low. The point is that the prices in the two cities are too far apart, making it possible for the arbitrageur to shave a profit irrespective of whether the prices go up or down so long as the difference between them is lessened. It must not be assumed that there is no risk connected with such transactions, for the arbitrageur can only make a profit provided his judgment has been correct and the difference in price between the two markets proves too wide so that the prices will be forced nearer together by the ordinary

market pressure. His profit will be equal to the amount that the difference lessens, minus expenses. On the other hand, should the difference in prices between the two markets spread further apart, showing his judgment to be wrong, he would suffer a loss.

It is also quite possible to make an arbitraging profit when there is too narrow a difference in the prices between two cities. The success in making an arbitrage transaction depends not only on the fact that the prices are not in proper relationship, but also that the purchase must be made in the market where the price is relatively low, and the sale in the relatively high market. This does not mean necessarily that the purchase will be made where the price is lower in amount, but it does mean relatively lower.

Arbitrage transactions can also be made between different delivery months; between different kinds of grain; and between two different grades of grain.

The effect which arbitraging has upon prices is that buying in Minneapolis would tend to raise the price and selling in Chicago to reduce the price, thus bringing the prices in the two markets into proper relationship. Arbitraging tends to even prices the world over and thus create a uniform world price, taking into consideration incidental and transportation expenses from one market to the other.

REVIEW

Define a "future."

What service do "futures" perform?

For what purpose are margin deposits required on future contracts? Show how a change in market price affects the marginal relationship of the parties to the contract.

What accounts for the difference in price between "spot" and "future" wheat in the same market and in different markets?

Explain the various ways you may arbitrage in the produce

CHAPTER XV

ORGANIZED GRAIN MARKETS

1. *Marketing of grain.*—The first step in the marketing of grain is its movement from the producer to the country elevators. When the farmers' grain has been threshed, they either sell it at once to the elevator companies or store it in an elevator and hold it on their own account. The thousands of country elevators located thruout the crop-producing regions are situated with reference to their accessibility to the grain fields as well as to railroad connections. These country elevators are the first buyers of the great bulk of our grain crops. The United States Bureau of Labor Statistics states in its bulletin, *Wheat and Flour Prices from Farmer to Consumer:*

> The province of the country grain elevator is to supply a market to the farmer for his grain, to afford a temporary storing place for grain going to market, and to provide an easy means of transferring it from the farmer's wagon to the car for shipment. . . . The farmer drives on the scales with his loaded wagon, which is weighed in gross, then drives into the elevator. Pulling off a lever, the wagon is tipped backward and all the grain runs out of the wagon box into the bin below. He then drives on the scales again and the empty wagon is weighed. From the difference in these weights the number of bushels is computed and then he receives a certificate of weight and possibly at the same

time a check for his grain. The wheat dumped into the bin below the wagon floor is hoisted by the elevator machinery to a bin in the elevator whence it is spouted into a car for shipment.

The grading of the farmers' grain at the country elevators is essentially a matter of local judgment. Here state regulation of grading and inspection is not so extensive as that in the primary grain markets.

Country elevators are of three kinds: (1) line elevators, (2) local grain dealers, (3) and farmers' co-operative elevators.

2. *Line elevator companies.*—A "line elevator company" consists of a chain of elevators which maintains its headquarters in the primary market. A line elevator company will own a large number of warehouses along one or more railroad lines. These line elevators have an advantage over others in that they are firmly established in most of the grain territory and are able to obtain a large portion of the crop. Their purpose is to acquire as much of the grain at its source as is possible. Their policy toward each other is not to compete but to divide the territory. They are in direct competition with the local grain elevator owners and, where possible, they either endeavor to buy out such competitors or to enter the territory and build an elevator of their own in competition.

The prices which their local agents pay the farmer for his grain are based on the prevailing price at the primary grain market and may be roughly defined as

the primary market price minus the cost of transportation, incidental expenses and a margin for profit. They are at an advantage because the large amount of grain they handle enables them to sell at the primary market thru their own agents, thus eliminating the commission man. The line elevator companies' profits are derived from the selling of the grain to the central grain jobbers or dealers, speculators, millers, exporters, and others, at a higher price than they pay the farmers. Most concerns do not take any chance on the fluctuating prices in the primary grain markets, so as soon as they purchase their grain they will immediately sell it in order to hedge and protect their trade profit.

3. *Local grain dealers' elevators.*—The local grain elevators were originally owned and operated by private individuals who lived in country places. They usually owned one or two of them, but because of the competition they have formed large "local grain dealers' associations." Their main reasons for the formation of such local associations were to obtain better treatment from the railroads, to bring about more favorable conditions in grading, inspection, weighing and dockage, and to encourage the farmer to bring his grain to the market in better condition. Some of the associations because of their strength have allowed objectionable features to creep in and have caused protests to be raised against them. The development of the line elevator companies and farmer's cooperative elevators has prevented their wield-

ing much of their former control. The method of carrying on the business of local grain dealers' associations is, in the main, the same as that of the line elevator companies, the one important exception being that they are not managed thru a headquarters in the primary market and as they do not have their own agents, they sell their grain thru commission men.

4. *Farmers' cooperative elevators.*—The method of operating farmers' cooperative elevators is approximately the same as that followed by the local grain dealers' associations. They too engage commission men. They are sometimes operated in connection with feed, flour, coal, lumber, farm machinery or other local business as a means of increasing the profits and reducing expenses of such enterprises. These farmers' cooperative elevators are mutual stock concerns, the farmers being the stockholders. An advantage which is derived from such a plan is that it is to the farmer's interest to sell his grain to his own company in preference to other elevator concerns, since as a stockholder he is interested in receiving larger dividends. In some instances the stockholders are allowed to sell their grain to other firms only if they are prepared to pay an agreed forfeit of one cent per bushel to their own company.

5. *Primary markets.*—The grain thus collected from the farmers in the local markets by the country elevators moves to the primary markets thru the elevator company agents, the farmers' own representa-

tives or commission men. These primary markets are located with special reference to transportation facilities to and from the numerous local centers of the grain trade. In nearly all cases they are situated on the interior waterways and it is by means of the numerous railroad routes entering the agricultural sections of the country that the grain is collected and readily shipped to the east or the south by the cheapest available route. Among the primary markets of the United States are Chicago, Minneapolis, Duluth, Omaha, Kansas City, Wichita, St. Louis, Peoria, Louisville, Cleveland, Toledo, Detroit, Milwaukee, Cincinnati, Indianapolis and Little Rock. Altho each of these primary markets collects its supply of grain from a particular grain growing section of the country, yet there is keen competition among them because of the fact that every large section may ship its grain to several other markets. This fact is of particular importance to the growers and local shippers of grain because of its favorable effect on grain prices. The prices at the various primary markets, however, are not usually, for any length of time, out of proper relationship to each other. As soon as there are abnormal price differences between markets, arbitrageurs, as we have seen, will enter the field and endeavor to make a profit, thus causing the prices in the various markets to be adjusted to their proper level.

6. *Terminal elevators.*—The terminal markets make possible organized exchanges because of the

concentration of such a large share of the grain crops of the country. Large terminal elevators are located at these points and here the grain is inspected, graded, weighed and stored. Some of them clean, dry and mix the grain and ship it to various parts of the world. The main function of the terminal elevators is the furnishing of storage facilities, for much of the grain cannot be stored by the country elevators because of their relatively small capacity. The capacity of these elevators is much larger than that of the country elevators and they are equipped for the handling and storing of large quantities of grain. Some of them are models of construction and by means of up-to-date equipment can load and unload from railroad cars to vessels and vice versa at very little cost.

7. *Seaboard markets.*—The grain which is shipped to inland transfer points and the seaboard market is handled by central elevators. Their functions are similar to the terminal elevators situated in the primary markets, except in some instances when their main purpose is that of transferring the grain instead of storing it. The leading seaboard markets are New York, Baltimore, Philadelphia, Boston, New Orleans, Galveston, San Francisco, Puget Sound-ports, and Portland, Oregon.

The function of the seaboard markets of the east is to distribute the grain in their sections of the country and export it to foreign markets. They are also ports of exit for grain exported from the interior.

The function of the seaboard markets of the Pacific coast is not only to distribute grain to the interior and foreign markets but also to serve in the capacity of primary and local markets.

8. *Commission men.*—We have already seen that the grain shipped to the primary markets by the line elevators is handled thru their own representatives, and then sold on the floor of the exchange. The other types of elevators sell thru commission men who in turn sell mostly on the exchange. These commission men render services to their customers by looking after the inspection and grading of the grain, weighing, freight charges, switching, dockage, storage and insurance. Furthermore they become a source of credit to the country elevators by supplying them with funds usually up to 90 per cent of the value of the grain shipped to them. The grain dealer attaches to the bill of lading, which he receives from the railroad, a draft drawn against the commission man and deposits it in the bank. The commission man sometimes goes so far as to extend credit to the country elevators on their open accounts without requiring collateral security. As his name implies, the commission man's profits are derived from his commission charge. His annual income depends on the quantity of grain which he handles in the course of a year. In order to secure an increase in his volume of business he employs agents to solicit shipments from the country elevators.

9. *Types of contracts.*—The country elevators sell

their grain to the terminal elevator companies by using any one of three types of contracts. The grain may be shipped on a "to arrive" contract which, according to the rules of the exchange, allows fifteen days from the time of sale to the time when delivery is required. Thus, it is possible for the shipper of grain to sell it before it arrives in the primary market. The seller simply agrees in advance to ship the required quantity of grain according to the contract and make delivery within the specified time.

A second method is the "on track" sale. In this instance when grain arrives at the primary market it is first weighed and graded and then sold in carlots, after which it may be shipped either to terminal elevators or to any place within the area covered in the switching limits of that market. These operations are handled by commission men.

A third type of contract is the "in store." Here the country elevator will store the grain in terminal elevators upon its arrival at the primary market and receive for it a regular warehouse receipt, the idea being to hold the grain in storage for a more favorable price than that prevailing at the time. When the time comes to dispose of the grain it is then sold "in store" and delivery is made by simply indorsing the warehouse receipt to the purchaser of the grain.

While most of the grain which is shipped to the primary market is sold to the terminal elevator companies, some of it is sold to millers, cereal food manufacturers, grain dealers other than warehousemen,

and exporters. It is the grain which is stored in these terminal elevators which is the basis of trading under the rules of the exchange. As already stated this does not necessarily mean that every time a sale is made the grain immediately leaves the warehouse. Warehouse receipts pass from hand to hand by endorsement but they eventually come into the possession of the millers, consumers, seaboard grain dealers and exporting concerns.

10. *Mixing of grain.*—The grain which the terminal elevators store nets them a storage profit, on which charges are limited by the States or grain exchanges. The other main source of profits is derived from the mixing of grain in the elevators. For example, number one grade of wheat may be mixed with number two grade and by so doing produce a number one grade for the bulk. This is made possible because of the prevailing system of inspection and grading of the grain, there being an inspection when the grain enters the warehouse known as an "in" inspection and another when the grain is sold and "loaded out," known as an "out" inspection.

Elevator companies are permitted only to mix grain which is their own property. Grain which is being stored for others, however, may be mixed, provided the elevator companies have been requested to do so, but in such instances it is necessary to store the grain in separate bins for purposes of identification. The elevators make a charge for this service and any profits derived from the mixing of the grain belong

to the owner. At first it may appear that the mixing of grain would be a somewhat objectionable practice but this does not necessarily follow. The mixing of grain renders a considerable benefit to farmers and dealers by making a market for low grade or "no grade" grain and, furthermore, thru the process of cleaning and drying, considerable improvement in the grain results. If it were not for this practice, low grade grain would be of no use and would be no source of profit to the farmer. The mixing and improving of the grain may, however, be objectionable if the inspection and grading is unfair or if the grain is scoured for the purpose of covering up defects. With the improvement of state inspection and grading of grain the objectionable features of mixing are gradually disappearing.

11. *Inspection and grading.*—The object of grading is to separate the grain into grades according to soundness, color and freedom from impurities. First, there are seasonal and color variances, which are often one and the same thing. The classification of winter wheat differs from that of spring wheat according to substance, color (white or red) and location (northern or western). Secondly, the appearance, the inherent quality of the grain, and its condition—its brightness, plumpness and sweetness, and the soundness of the berry—must be considered. Thirdly, the question as to whether the grain is free from foreign substances, such as chaff, and from any admixture of other kinds of grain, is also carefully

considered by the inspector before the product is assigned to a definite class.

To go back to the original source of the grain, we have, in those sections of the country where only a small quantity is produced, practically no definite system of grading. The method is simply that of buyers making offers to the farmers for their grain. In those sections where the raising of grain is carried on extensively the grain is graded by the local purchaser or by grain inspectors who represent the combined group of buyers. It is only when the grain reaches the primary and seaboard markets that it is graded systematically either thru the grain exchanges or by state inspection. In most states where grain is the principal staple, public grain inspection bureaus have been established and the inspection is performed by public officials.

The first system of inspecting and grading of grain was established in 1858 when the Chicago Board of Trade adopted rules for determining the various grades according to quality, color and general conditions. It was in the same city that the first state grain inspection took place. Until 1904 the so-called "track system" of inspection universally prevailed there. Grain was inspected on the cars in the open freight yards. The disadvantages of this system were that the grain was inspected under all kinds of weather conditions, which at times caused undesirable moisture in the grain as well as having a detrimental influence on the judgment of the in-

spectors, often causing a variance of opinion among them.

As a result of the defects of the track system the "room" or "office" inspection has been established in Chicago and other primary markets. This system of inspection is a considerable improvement over the other method, as it is carried on indoors. Here the combined judgment of several inspectors takes the place of that of one individual. There is also the advantage of a laboratory to enable the inspectors to determine more accurately the percentage of moisture in the grain.

12. *Illinois state inspection system.*—Since Chicago was the first to establish a system of state inspection and is the leading grain market of the world we shall consider the operation of the Illinois system as a standard for illustrative purposes. The first step is for the railroads to give notice to the inspection department of all cars of grain as they arrive at the freight yards. A corps of state samplers collect samples of grain from these cars, each sample consisting of a two quart bag of grain taken from different parts of the car. These samples are sent to the inspection department where they are emptied into tin pans for the purpose of grading and inspection. When doubt arises as to the grade which should be given, that is, the sample represents what is known as a "line car," the chief inspector is called upon to assist in rendering proper judgment. Often, when it is particularly difficult to determine the grade, all

the inspectors will be required to gather around the table to give their opinions and the reasons for them.

When the sample has been given its grade, it is put back into the bag and a card is inserted on which is indicated the grade given. The sample accompanied by the card goes to the official record writer who enters upon a record sheet, the name of the inspector who graded the grain, its grade and reasons for giving the same, name of the railroad which delivered it, car number, name of consignee, and the number indicating the hook on which the sample is hung. Both sample and card now pass to the "splitting" department where the sample is carefully examined by two inspectors for the purpose of verifying the first inspection. Here each sample is divided into two equal parts, one part being placed, together with the railroad notice, in a paper bag. One part of the sample is then quickly sent by messenger to the Board of Trade and turned over by that organization to the firm handling the shipment. The other half of the sample is preserved for twenty-four hours and then emptied.

When there is objection raised as to the grade given, a re-inspection form is filled out and in less than a half hour the grain may be again inspected. If there is still dissatisfaction after the re-inspection has been made an appeal may be taken to the "Appeals Committee." Under the laws of the State of Illinois this committee must consist of three competent and discreet individuals experienced in the qual-

ities of grain. Furthermore, they cannot be connected with the inspection department or engaged in the purchase or sale of grain. Their duties require them to visit the car or vessel, obtain fresh samples and examine them and pass upon them. The majority opinion of the committee is final and binding.

13. *Out-inspection.*—The system of inspecting the grain in this way as it arrives in the primary markets, is quite satisfactory. It is the purpose of the inspection department to make its inspection of grain as it is "loaded out" equally as rigid. We have already seen that a difference in the quality of the grain is produced thru mixing and a profit can thereby be derived. In order to make the "in" and "out" inspection equally severe the inspection department re-inspects the work of the so-called house inspectors who station themselves at the elevators and grade the grain as it is shipped out. The inspection department requires samples to be carefully drawn from each car or vessel, and sent by special messenger to the main office where it is re-inspected by a board of inspectors under the personal supervision of the chief inspector. If the decision of the board is different from that of the house inspector the house inspector is notified and the grades are changed to comply with the board's judgment.

The main trouble in the grading of grain in the past was the lack of uniformity in the grading system of the various states. The constant demand from foreign representatives for uniformity in grad-

ing rules and the many complaints of our own countrymen caused Congress in 1906 to authorize the Secretary of the Department of Agriculture to collect facts and data relative to the handling of grain which would enable him to fix and establish uniform grades.

14. *Federal Warehouse Act.*—After ten years of investigation, Congress passed, on August 11, 1916, a Warehouse Act and a Grain Standards Act. The Warehouse Act authorized the Secretary of Agriculture to investigate the storage, warehousing, classifying according to grade and otherwise, weighing and certifying of agricultural products including grains, cotton, wool, tobacco and flaxseed, if stored for interstate or foreign commerce; to issue warehouse licenses; to inspect licensed warehouses; to determine storage character, to classify storage according to ownership, location, surroundings, capacity, conditions and other qualities; and to prescribe the duties of the licensed warehousemen with respect to their care and responsibility for agricultural products stored in their establishments. The warehousemen must agree, as a condition to the granting of a license, to comply with all the terms of the Act and the rules and regulations prescribed thereunder. Warehousemen must furnish satisfactory bond to secure the faithful performance of their obligations under the Act. They must receive for storage all grain without making any discrimination, as far as the capacity of their plant permits. Inspection and grading products for interstate or foreign commerce must be

performed by a person duly licensed under the Grain Standards Act. Each depositor's product must be kept separate, unless otherwise permitted, so as to permit proper identification and re-delivery of the product deposited.

The Secretary of Agriculture may, from time to time, establish and promulgate standards for agricultural products by which their quality and value may be judged and determined, such standards to be known as the "official standards of the United States" for the agricultural product to which they relate. The warehouse receipts issued must embody a large number of the facts and conditions of the law.

There is nothing in the Warehouse Act that is to be so construed as to conflict or impair the effect of the laws of any state relating to warehouses, warehousemen, weighers, graders or classifiers. As a matter of fact, the Secretary of Agriculture is authorized to cooperate with officials charged with enforcing such state laws.

15. *Grain Standards Act.*—The purpose of the Grain Standards Act is to establish standards of quality and condition for wheat, corn, rye, oats, barley, flaxseed and other grains. The act authorizes the Secretary of Agriculture to investigate the handling and transportation of grain and further provides that when standards have been established for any grain, no person shall thereafter ship or deliver for shipment in interstate commerce any grain which has been sold, offered, or consigned for sale by grade unless

such grain has been inspected and graded by an inspector licensed under the Act. It does provide, however, that any person may sell or ship such grain other than official grades by sample, or under any name or description or designation which is not misleading, and that such grain may be sold or shipped in interstate or foreign commerce without inspection at point of shipment or en route but subject to inspection at destination, also without inspection if there is no inspector at either end of the journey.

Where disputes arise as to the grade of grain, whether it is with or without inspection, appeal may be made to the Secretary of Agriculture who is authorized to cause investigation to be made and tests applied to determine the grade. The findings of the Secretary are accepted by the Courts of the United States as *prima facie* evidence. Infractions of the law are investigated and punished, and inspectors may also be punished for not living up to requirements made by the Act. Within three years from the passage of this act grades had been established for wheat, corn and oats.

16. *Results of the Act.*—By means of education the natural indifference and antipathy which was first shown toward the Act has been overcome and grain supervision advanced beyond the actual requirements of the law. It has extended its task to showing to grain men, in the more remote districts, how and why grain should be graded. In making the standards of grain, the factors considered were those

with which the grain men were already generally familiar. The farmer, however, was not interested in these matters, or familiar with them, and depended in most instances on the judgment of the buyer of his grain. Exhibitions of equipment and demonstrations of grading were given by the United States Department of Agriculture at grain schools, agricultural colleges, grain associations and country fairs; addresses were made before all sorts of grain gatherings. All these mediums were given a part in this campaign of education; but despite all this propaganda work, even now only a few individuals appreciate what the Act has already accomplished. It has among other things placed a premium on the quality of the grain raised and given an incentive to the farmer to produce a better product. Business practice of an unfair nature has been checked and a square deal has been assured to the purchaser of grain. Furthermore, it has established the confidence of foreign countries in our grain traders.

REVIEW

Outline the various steps in the marketing of grain.

What types of elevators are there? Explain their differences.

Explain what you understand by a "to arrive contract."

Do you approve or disapprove of the mixing of grain? Why?

Explain the system of grading and inspection of grain.

What did the Federal Warehouse Act and the Federal Grain Standards Act accomplish?

CHAPTER XVI

THE CHICAGO BOARD OF TRADE

1. *Chicago, a world market.*—Chicago is the world's foremost clearing house for grain and the largest shipping point for wheat. Not only does the grain business form a large portion of its commercial activities, but Chicago's enormous trade in many products which depend upon the cereals, such as live stock, cured and dressed meats, ribs, pork, lard, hides, cheese and butter, is due to its dominance in the grain trade.

Chicago is close to the great wheat and corn states. It is centrally located for rail and water transportation. In addition to the trading in wheat there are transactions involving hundreds of millions of bushels of corn and oats. Trading in excess of the crop is made possible thru speculation in futures, which assures dealers the world over an opportunity at all times to buy or dispose of any quantity of grain, wheat especially.

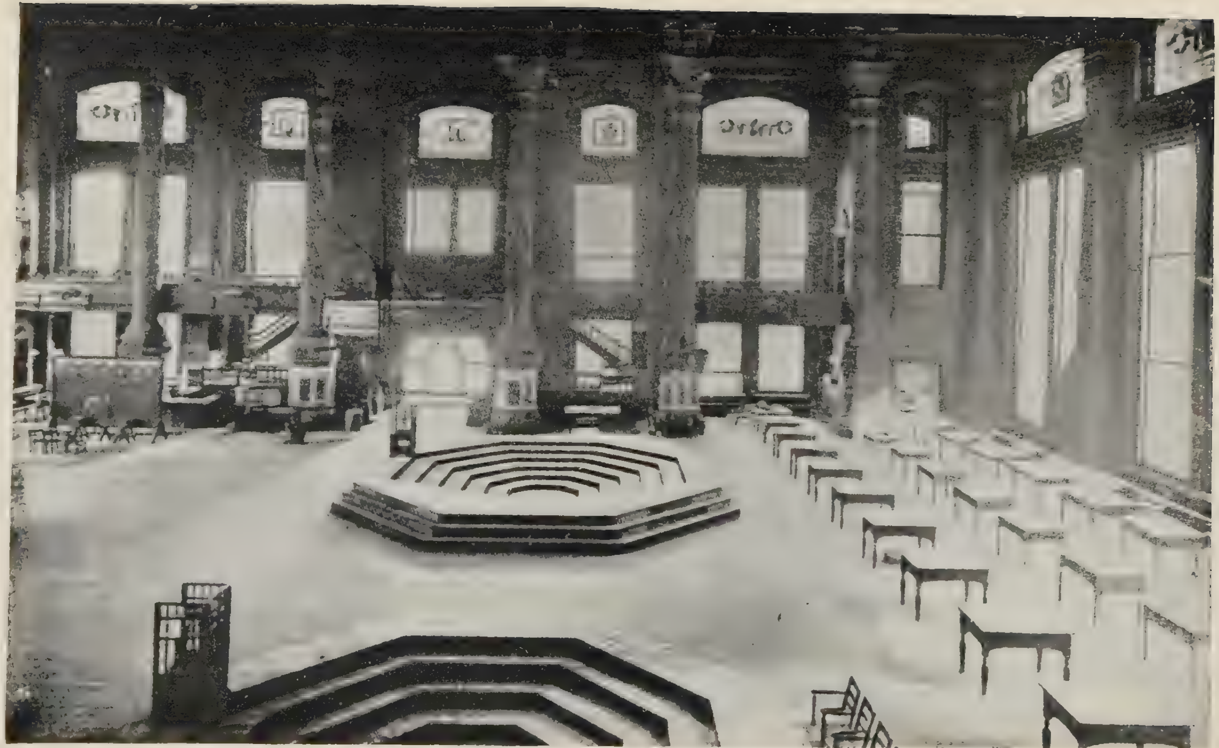
The Chicago Board of Trade, next to the market of Liverpool, tends to dominate the prices for grain. Some idea of the importance of this organization may be had when we reflect that the volume and the value of the grain crops have an immense influence upon

railroad traffic and earnings, upon money rates and prosperity generally. The country miller of Illinois, the grain buyer of Iowa, the elevator manager of any center, the big Minneapolis miller, the terminal elevator company of Chicago, the exporter of New York and Argentina, and the importer of London, Liverpool, Amsterdam and Antwerp—all come here to buy and sell wheat as a "hedge" against transactions in their regular business activities.

2. *Government and membership.*—The government of the Board of Trade differs little from that of the stock exchanges. In what may be called the machinery of operation, the main difference consists of the substitution of committees on inspection, weighing, grading and sampling of grain for the regular stock list committee of the exchange.

The Board of Trade publishes elaborate annual statistics concerning grain prices in addition to furnishing the familiar quotations on transactions. As on stock exchanges, there are rulings regarding charges to members and non-members. The usual commission is one-fourth of a cent a bushel. On transactions made for members, the rate is one-eighth of a cent. Members trading in the pit for their own account pay $1.25 per 5000 bushels. Corporations pay one-eighth of a cent when they have one director or stockholder who is a member of the Board of Trade.

The membership totals between 1700 and 1800 and includes a representative of nearly every important grain commission and elevator company in the coun-



FLOOR OF THE CHICAGO BOARD OF TRADE

The picture shows two of the four pits on the floor, in the foreground the corn pit, in the background the wheat pit

try, many of the big millers, some of the New York Stock Exchange members, even a few European importers, several hundred local grain commission men, elevator managers, flour merchants, insurance men, grocers, shipping merchants, lawyers, lumbermen, several capitalists and bankers, and owners and representatives of the packing houses.

3. *Methods of trading.*—Some of the exchange houses handle mostly speculative business; others buy for the big mills and for export. As on the stock exchange, there are commission brokers, members who execute orders for other members, and traders, who are the professional speculators. These latter are sometimes called "scalpers." The transactions on the exchange are of the two general kinds: the "cash grain" business and the "future" business. Under the former come all the dealings which pertain to the actual grain—wheat, corn, oats, and so on, selling it by sample. One side of the exchange room is given up to this "cash" business. Here the samples are laid out for inspection of the various buyers.

The rest of the exchange floor is given over to the future markets. The five points about which the buyers and sellers habitually congregate are called "pits." The pit corresponds to the "post" or "crowd" on the stock exchange and consists of a circle of steps leading up from the outside and down into the center. It is arranged so that a maximum number of people on different levels can see and hear each other in a minimum of space. Telegraph op-

erators sit on raised platforms near the pit and transmit quotations. The word "pit" permeates the phraseology of the Board of Trade. Instead of "room" or "floor" traders we have "pit" traders; pit is almost a synonym for market. Sales involving thousands of dollars are consummated by a single word, by a nod of the head, or by a distinctive gesture; and each party merely jots down on a little card a memorandum of the transaction. In no other business, except perhaps in stock trading on the exchanges, are such important deals made with so little bickering over details, or with such implicit confidence that the contract will be faithfully carried out.

On the floor of the exchange, there are the wheat pit, the corn pit, the oat pit and the provision pit. During busy times, the combined markets present a scene of activity, intenseness and seriousness, and not infrequently of excitement also, such as is seen nowhere else except on the floor of the New York Stock Exchange. During a very active market the wheat pit is crowded with some three hundred and fifty or so, struggling, shrieking men endeavoring to execute their orders. At such a time every one in the exchange room seems to have a realizing sense of the importance of the momentous volume of business that is being done. It is a time when moments are precious, and a few seconds suffice to complete transactions. This necessitates the greatest possible rapidity and alertness, physical and mental, that human beings are capable of, and the aid of all the me-

chanical appliances that may be had. Orders are continually coming to the floor by telephone and by telegraph, and messengers are speedily delivering them. From the time the gong sounds in the morning until it announces the close in the afternoon there is no time or thought during an active market for anything but the business of the moment. What happened a minute ago is past, and that which is to be done a minute hence will be attended to when it is reached.

The orders received by the brokers in the future markets come from every conceivable source. Broadly speaking, however, these orders may be divided into two chief classes. In the first class are orders sent by men who intend to receive or deliver the actual grain at some time in the future. These men take advantage of the market which offers them an opportunity to insure themselves against loss of profits which may take place, due to a change in the price of some commodity upon which their business depends. This method of insurance is termed "hedging" and has already been described. The second class of orders is received from senders who never intend that they shall be filled by the actual receiving or delivering of the grain. These traders expect to get rid of either obligation by selling on a basis of "differences." That is, instead of delivering the actual commodity which the contract calls for, the seller gives the buyer the difference between the price of the commodity on the delivering date and the price

agreed upon when the contract was made. Such orders are called speculative, as they are sent in by men who buy and sell without expecting to use the grain or even to see it. They hope to "sell out their trade" at an early date and to reap a profit by a change in price.

4. *Methods of payment.*—The methods of payment in the board of trade are made to conform to the system of future trading. The rules provide that all deliveries upon contracts of grain, *unless otherwise expressly provided,* shall be made by tender of regular warehouse receipts, which are evidence of grain stored in the elevators. The holder of a warehouse receipt upon its presentation to the warehouse receives the actual commodity. In spite of this, however, it is true that the warehouse receipt does not necessarily pass from hand to hand every time grain is sold.

Since a large bulk of the buying for future delivery is for the purpose of making a profit thru price fluctuations, the speculator will sell his future contract within a short time and take his profit or loss as the case may be. The short seller occupies a similar position. Having made his sale, he will later buy and even up his transaction. In making delivery on these contracts the seller would deliver warehouse receipts to the buyer, but this would involve the necessity of endorsing such receipts each time delivery is made; and besides, there would be considerable risk in

passing such a valuable piece of paper from hand to hand. The Board of Trade rules provide that delivery may be offset by some corresponding trade or contract if such offset is consented to by all parties and that balances shall be paid immediately. Thus two contracts, which agree in all particulars except price, may be offset and may be settled by a payment of price differences. With many persons buying and selling grain, who really do not want the commodity, the seller instead of making delivery by the transfering of warehouse receipts issues a "delivery" or "transferable" notice which notifies the buyer that he, the seller, stands ready to deliver warehouse receipts in fulfillment of his contracts. Warehouse receipts therefore are delivered only when a contract is closed out by delivery of the actual grain.

Out of a number of transactions that are made, there may be only two parties who are concerned in the actual handling of wheat—a seller who actually owns wheat and a buyer who desires the grain for industrial use or export. The other intervening parties are interested, not in the actual grain itself, but in settling the differences between their buying and selling prices. Their purpose is accomplished by the original seller who is the holder of grain issuing this so-called "transferable notice" to the party to whom he sold. Each seller in turn properly endorses the notice and passes it on until it comes to the person who actually desires delivery of the grain. This person will present the notice to the individual or com-

pany who issued it—the holder of the wheat—and in return receive warehouse receipts. On presenting the warehouse receipts at the proper elevator he obtains the wheat.

At this point the question arises as to how settlement of these contracts is made. Between the seller and the receiver of the wheat there are no direct contract relations, and the price at which the one agreed to pay for the wheat may be different from the selling price of the other. Settlement is made according to an "official" settlement price, which is an arbitrary price at about an average quotation of the previous day's transactions. At this price, payment is made to the original seller on the "transferable order" by the person who wants the actual wheat. It is hardly likely that this price would very often be the same as the contract price the buyer and seller had made. The differences in contract prices which exist between the various parties in the chain of transactions are settled by paying or receiving on the basis of the official settlement price.

5. ***Ringing out.***—Another method of settlement which is similar and yet unlike the "transferable order" method is called "ringing out." This method is followed where all the parties to a group are speculators and none of them are holders of the grain they sell and when none of them are desirous of receiving the actual grain on their purchases. All that is necessary in the "ringing out" method is simply to settle

the differences representing the profit or loss of each individual.

For instance, A sells wheat to B. Both are speculators, neither one caring about the handling of the actual wheat. A is a short seller selling that which he does not possess and B buys wheat which he does not want. A to cover on his short sale buys wheat from B, and B to close out his contract sells to A. It can be readily seen that it would be useless to make deliveries in this case. A would be simply receiving from B that which he would be returning to B. This sort of a transaction is closed by simply paying the differences in prices at which the transactions were made. When there are several parties concerned, the principle is extended still further. To illustrate, suppose A sells to B, B sells to C a similar amount of wheat, and C in turn sells to A. In this instance C, the last purchaser, has sold to the first seller A, so that deliveries become unnecessary as all parties are speculators and desire only to adjust their profits or losses. In adjusting settlement under the ring method the situation is a little more complicated than where the settlement is made direct between two parties, but the principle is the same.

Let us take a more concrete illustration where A sells 5000 bushels of wheat to B for $1.01 a bushel, B sells to C for $1.03, C sells to D for $1.02, D sells to E for $1.04, E sells to F for $1.05 and F in turn sells to A for $1.00. Of course B could pay to A

$5050, the purchase price of 5000 bushels at $1.01, and C could pay B $5150 his purchase price, and so on. This would involve the passing of considerably larger funds than if checks were drawn simply to represent price differences. A in this case has a profit of one cent on each bushel, B a two cent profit, D a two cent profit, and E a one cent profit, the total profits of all being six cents. But C had a one cent loss and F a five cent loss, making the total losses six cents, the profits and losses being equal. All that is necessary for those who have losses is to pay the differences to those who have profits and settlement of the ring is made. The profits and losses, however, are calculated on the basis of an official settlement price, but it makes no difference in the profits or losses of all parties concerned whether settlement is made according to the contract prices or by an official settlement price. The proof of this illustration we have already seen in the settlement of stock transactions.

6. *Produce clearing house.*—The clearing house furnishes the most improved method for facilitating the settlement of contracts. It resembles bank clearing houses in large financial centers. The economic importance of the clearing-house system rests in the saving of time and the friction which frequently arises in the settlement of a large number of accounts, by affording a central office with an organization of trained officials where the numerous transactions can be cleared. It also reduces the amount of cash or credit required to make settlements. The clearing

house is an independent organization with its own set of officers, rules and regulations. Its function is to keep a record of the sales and to open accounts with the exchange members.

In order to facilitate the settlement of contracts by offset, each member is required to keep a "settlement book," in which shall be entered the names of parties with whom settlements have been made, the dates and terms of such settlements, the prices at which the commodities were originally sold or purchased, the amounts due to or from him or them on each separate settlement, and also the net amount due to or from him or them on all settlements.

When the business day ends the members go to the clearing house and pass in their accounts or "reports." If the clearing house sheet as made up shows a credit to the owner of the "report," a draft for the correct amount is drawn on the clearing house. If the day's dealings have netted the member a loss he passes a check for that amount to the clearing house. The clearing house performs the settlement and obviates the necessity of each member hunting out those with whom he has made contracts during the day.

Thru the buyer's offsetting or cancelling his purchase by a sale and by means of the clearing house and ringing out, contracts are settled by the payment of differences only and these differences are cleared each day, a single check or draft settling the individual's total loss or gain for any given day. Where trades are made which require the actual delivery or payment the transfer is made by the transferable or-

der, and as explained, the payment is made at the settlement price between the original seller who has grain in his possession and the last buyer who wants it. The purpose of the clearing house is for the clearance of differences only.

7. *Legal aspects.*—Contracts, whether delivery of the product is made thereon or not, are binding and are representative of the actual grain. Even tho it does so happen that future contracts are often made for the purpose of gambling, nevertheless, delivery of the actual product may be demanded. Where statutes do not prohibit it, and where there is absence of proof that a future contract is made for the purpose of wagering and upon which no delivery is intended or expected to be made, such contracts are considered legal and binding and will be considered so by the courts. The Supreme Court of the United States holds that "set off has all the effects of delivery." In a decision of May 8, 1905, the following opinion was rendered:

When the Chicago Board of Trade was incorporated we cannot doubt that it was expected to afford a market for future as well as present sales, with the necessary incidents of such a market, and while the State of Illinois allows that charter to stand, we cannot believe that the pits, merely as places where future sales are made, are forbidden by the law. But again, the contracts made in the pits are contracts between the members. We must suppose that from the beginning as now, if a member had a contract with another member to buy a certain amount of wheat at a certain time and another to sell the same amount at the same time, it would be deemed necessary to exchange warehouse re-

ceipts. We must suppose that then, as now, a settlement would be made by the payment of differences, after the analogy of a clearing house. This naturally would take place no less that contracts were made in good faith for actual delivery, since the result of actual delivery would be to leave the parties just where they were before. Set-off has all the effects of delivery. The ring settlement is simply a more complex case of the same kind. These settlements would be frequent, as the number of persons buying and selling was comparatively small.

The fact that contracts are satisfied in this way by set-off and the payment of differences detracts in no degree from the good faith of the parties, and if the parties know when they make such contracts that they are very likely to have a chance to satisfy them in that way and intend to make use of it, that fact is perfectly consistent with a serious business purpose and an intent that the contract shall mean what it says.

8. *Influences that govern the price of grain.*—Speculation in commodities, like that in stocks, is concerned with the future rather than with the present. To ascertain what will take place at some future date as regards wheat, corn, cotton and the like, requires a study of every element and condition involved in the growth of these great staples. For this reason the Board of Trade and every other produce exchange undertakes to collect and distribute broadcast a detailed and intricate mass of economic information. Having studied the influences that affect the price of stocks, it will be apparent that the stock and the produce markets differ radically in one respect. Which is the more difficult to understand, interpret and forecast, it is impossible to say. General financial and money market conditions, wars, disasters and

prosperity, or its reverse, naturally affect both markets, but besides these general conditions, it is necessary in the stock market to study the status of individual corporations, of which there are thousands. The case of the produce markets is different. They handle only four or five different commodities, and the chief characteristics of these are easy to comprehend. There is, however, a mass of technical detail connected with the innumerable and intricate agricultural conditions affecting the various crops, which complicates the produce exchange calculations to about the same degree of intricacy obtaining in the stock market.

The market price of wheat is an equation between supply and demand. Nowhere else, perhaps, does the law of supply and demand work so clearly and openly. If there is a huge crop of wheat and people do not want much wheat, obviously the price will fall. If the consumers want a great quantity of wheat and have the money to pay for it, clearly the price will rise.

The problem of supply is much more intricate than that of demand. The recent war apparently increased the demand for grain products. In reality, the supply having been cut off from some countries by naval operations and cessation of production, other consuming countries demanded more from the few nations that grow wheat and were still free to carry on export trade.

9. *Foreign influences: the Liverpool market.*—The

price of wheat is determined by international rather than by local or even domestic influences. Many countries in all parts of the world produce wheat and harvest the crops during no less than ten months of the year. Since wheat can easily be shipped from one part of the world to another, the price is largely the result of the variations in the supply that comes from many different countries. Certain countries consume more wheat than they produce, and consequently must import from countries that produce more than they consume. The principal importing countries occupy a relatively small area of the earth's surface, and are all crowded together in western Europe. Great Britain does the most importing, and Liverpool is the principal wheat market in that country. Thus surplus wheat tends to flow towards Liverpool, and the Liverpool price dominates the world markets.

Indeed, prices in even the smaller markets always tend to approximate the Liverpool price, minus freight, handling, insurance and other charges. If, then, every producing country has a large crop, Liverpool does not have to pay much to attract wheat. If, on the other hand, all producers have small crops, Liverpool must pay exorbitantly. If most of the growing countries have small crops and a few have large crops, the few will, of course, receive a big price for their large crops. The question is often asked whether farmers are better off with small crops and large prices, than with large crops and small prices.

The answer depends not on one country alone, but upon the conditions in the world markets.

The supply of wheat is dependent upon many conditions: drought, floods, early frost, black rust, and insect pests, all of which are fatal to the wheat crop. The following is an estimate:

> Every inch of rainfall above four inches in the Dakotas, California, Washington, Kansas and Nebraska in May and June means an increase of $15,000,000 in the wheat crop, and every inch of rain above three inches in July, in Indiana, Illinois, Kansas, Iowa, Ohio and Nebraska increases the value of the corn crop by $160,000,000.

10. *Sources of market information.*—The Federal government, thru the Department of Agriculture, publishes frequent crop reports. These constitute the most important single source of information, but there are countless other sources. Grain houses employ crop experts, who scour the country in search of data. The railroad companies whose lines run thru crop countries also issue reports, and there are countless facts gathered from the correspondents of banks, brokers and newspapers located in different sections of the grain producing area.

There is always uncertainty as to the final harvest of any product until it is actually gathered. While the crops in the United States are growing, the market may have half a dozen crop scares. Meanwhile, the operators watch the growing crops in other producing countries such as Canada, Russia and the Ar-

gentine. The situation is complicated by the fact that when any estimate is made as to what prices should be, the "visible supply"—meaning the amount in storage, or in transit which has been left over from last year—must always be taken into consideration; and, of course, this "visible supply" varies from year to year. In addition, the broker and the speculator must watch the prices of wheat on all the exchanges —no easy task, for there are nearly a dozen of them in the United States.

11. *Conclusion.*—The purpose of this volume as the reader has seen, has been to disclose the interior and exterior functioning of stock and produce exchanges. We have shown that these exchanges are located in virtually all the large cities of the world and that they perform a very necessary economic function. On the other hand we have seen that many evils and abuses have crept into their system of trading even tho, according to the rules and regulations of each and every exchange, they endeavor to transact business on a high plane of commercial honor.

A great deal has been heard and written concerning the unfavorable aspects of exchanges. They have been described as "the bottomless pit, and worse than all the hells." Statements of this sort are usually made by those in sympathy with individuals who have either dishonestly or ignorantly abused the facilities of the exchanges. Often such statements are made by those ignorant of the economic functions rendered by organized markets.

It is a truism, but one well worth repeating, that abuses are found in every important branch of business and political life. This does not necessarily indicate that the business or government in which these abuses are found should be abolished, but simply that improvement is needed. There is no question that an institution which holds such an important position in the mechanism of modern business is here to stay. Its place is assured. As time goes on the evils of exchanges will undoubtedly lessen thru publicity and the legitimate functions become more generally recognized.

REVIEW

How do you account for Chicago becoming the world's foremost grain market?

Compare the interior of a produce exchange with that of a stock exchange.

How are deliveries upon contracts of grain made? Explain what you understand by a "transferable notice."

Work out a hypothetical problem showing how settlement is made by "ringing out."

What is the nature and function of the Produce Clearing House?

What are the factors which affect the price of grain?

What are the sources of produce market information?

NOTE: Numerous questions of business practice and procedure are discussed in detail in the Modern Business Reports. The current list gives titles of Reports in the field of corporation finance and investment which are more or less related to the subject of the present volume.

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